SOLGM

NEW ZEALAND SOCIETY OF
LOCAL GOVERNMENT MANAGERS

MORE DOLLARS AND SENSE

FINANCIALS AND THE LONG-TERM PLAN

AUGUST 2011

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FOREWORD

More Dollars and Sense: Financials and the Long-Term Plan is the fourth of the SOLGM Guides to Long-Term Planning to be revised in advance of the 2012-22 long-term plans. Others in the revised suite are:

- *Living Through (Another) Long-Term Plan* – released on 29 October 2010
- *Performance Management: Still Your Side of the Deal* – released on 20 December 2010
- *Jigsaw III – Producing An Integrated Long-Term Plan* – released on 23 December 2010
- *The SOLGM Long-Term Planning Seminars* – to be held in March and April 2011
- *Long Term-Planning for Decision-Makers* – guide to be released in April 2011.

SOLGM's revision of its guidance on long-term planning has been based on seven principles (which we call the seven pillars of wisdom in long-term planning). These are:

1. *Long-term planning is long-term* – delivering services to the community on a sustainable basis requires thinking beyond the next year and the next triennium
2. *The Right Debate* – getting the most from long-term planning is about creating and managing the right debate with the public. This right debate will focus on the council's overall bundle of level of service, funding and policy choices and how these contribute to wellbeing.
3. *Plan Your Plan* – successful long-term planning requires careful sequencing of determining and debating future intentions, and producing information that sets out the consequences.
4. *One Coherent Story* – a long-term plan should tell a single overall story – at its most basic the content of the story is about community wellbeing and the things the council will do to make people's lives better
5. *Answer the 'Why' Question* – being able to clearly and succinctly describe why your council does a particular activity, in terms that are relevant to the public, is critical to good long-term planning
6. *The Flow of Logic* – each of the elements of a competent long-term plan will link with others in a logical way. A reader should be able to see a link between a financial strategy, the funding tools and the forecast financial statements. The choice of levels of service will determine what measures and targets councils use to assess their performance, and changes in levels of service will be reflect in asset plans and expenditure information
7. *The Continuous Plan* – planning is an ongoing process, not just a triennial document.

This Guide deals with the financial aspects of the long-term plan. While financial information forms only a part of the LTP – the financial consequences of the LTP are often the yardstick that the public and many elected members judge the LTP by.

At the time of writing Parliament has just enacted the so-called "TAFM" package of reforms to the Local Government Act. Arguably the most significant changes in the Act have been made with the intention of improving the transparency of local government financials for the general public.

The main theme of this particular guide is the importance of a robust financial strategy to the long-term plan and to financial management in general. Financial strategies are about more than limits on rates and debt that have been plucked from thin air, instead they are a tool for ensuring sustainability of service while also acting as a tool for prioritising and for communicating with the community.

Guides like this do not just happen, but are the product of the work of the following people:

- Janine Becker, Finance Manager, Environment Waikato
- Carolyn Howard, Dunedin City Council

- Christine Jones, Group Manager City Directions, Tauranga City Council
- Steve Kelsen, Funding and Financial Policies Manager, Christchurch City Council
- Sarah Lineham, Sector Manager – Local Government, Office of the Auditor-General
- Mike Nield, Director Corporate Services, Taranaki Regional Council
- David Paris, Manager Finance, Masterton District Council
- Murray Staite, Corporate Services Manager, Tasman District Council.

I also want to thank:
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- Jonathan Salter, Simpson Grierson, for the legal review.

Clare Hadley
President, SOLGM
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Contents

Foreword . . . 3

Summary: Financial Management for the Time-Challenged . . . 7

Part One: Introduction . . . 11

1.1 What is this Guide? . . . 11

1.2 What is Financial Management Under the *Local Government Act*? . . . 11

1.3 Principles . . . 11

1.4 How to Use this Guide . . . 13

Part Two: Prudence and the Balanced Budget . . . 15

2.1 The Hierarchy of Financial Management . . . 15

2.2 Prudence . . . 16

2.3 The Balanced Budget Requirement . . . 19

Things to Remember . . . 23

Part Three: Financial Strategy . . . 24

3.1 What is a Financial Strategy? . . . 24

3.2 Content of a Financial Strategy . . . 26

3.3 Preparing a Financial Strategy . . . 27

Things to Remember . . . 36

Case Study – Manukau City Council . . . 37

Part Four: Funding and Financial Policies . . . 43

4.1 Funding Principles and Process . . . 44

4.2 *Section 102* Policies – the Legal Requirements . . . 50

4.3 Revenue and Financing Policy . . . 51

4.4 Policy on Development or Financial Contributions . . . 59

4.5 Liability Management Policies . . . 60

4.6 Investment Policies . . . 61

4.7 Remissions and Postponement Policies . . . 62

4.8 Māori Freehold Land . . . 63

Things to Remember . . . 67

Part Five: Financial Forecasting and Modelling 68
5.1 Forecasting Assumptions 68
5.2 Modelling Tools 74
Things to Remember 75
Part Six: Financial Statements 76
6.1 Why Are Financial Statements Important? 76
6.2 Developing Financial Statements – Some Principles 77
6.3 GAAP Financial Statements 77
6.4 The Funding Impact Statement 79
6.5 Additional Disclosures 83
Things to Remember 85
Part Six: Appendices
6.1 Funding Impact Statement for Long-term Plan (Whole of Council) 86
6.2 Funding Impact Statement for Long-term Plan (Group of Activities) 88
6.3 Funding Impact Statement for Annual Plan (Whole of Council) 90
6.4 Funding Impact Statement for Annual Report (Whole of Council) 92
6.5 Funding Impact Statement for Annual Report (Group of Activities) 94

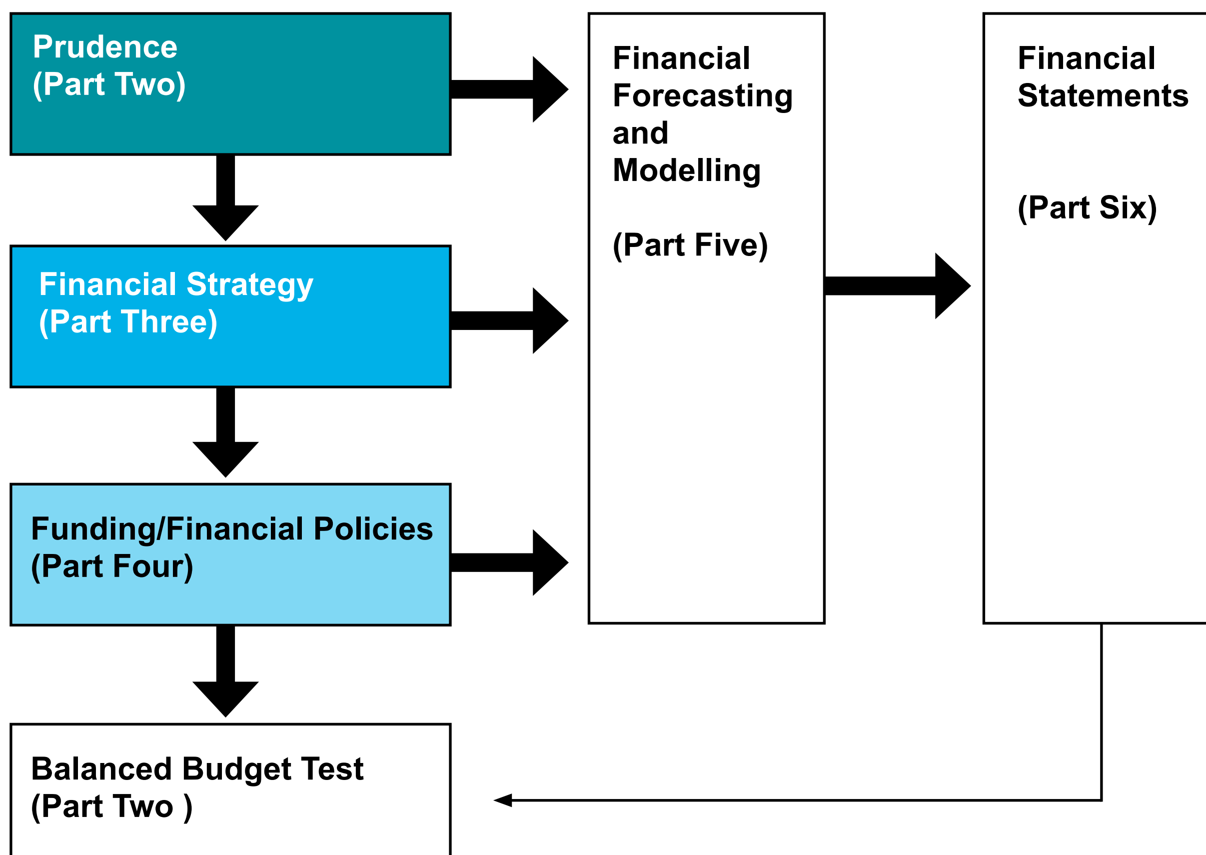
Disclaimer

This guide represents the collective wisdom of the local government sector with respect to performance management under the Local Government Act 2002. Every effort has been made to ensure that the information in this guide is as accurate as possible, including review by legal advisors and representatives of the Office of the Auditor-General.

The guide is <u>not</u> a substitute for appropriate legal and policy advice. Neither SOLGM nor the individuals involved in the preparation of this document accepts any liability for loss or damage arising from the use of material contained herein. Reading or using the information beyond this point constitutes acceptance of the terms of this disclaimer.

SUMMARY: FINANCIAL MANAGEMENT FOR THE TIME-CHALLENGED

This guide follows this basic roadmap – with each part corresponding to a different part of the map:



Prudence and the Balanced Budget

The Act places four main financial obligations on local authorities, that is:

- financial management that is prudent and in the current and future interests of the community
- adoption of a financial strategy
- adoption of a set of funding and funding policies (including following a two step process when deciding how to fund your services and activities)
- balancing the budget.

There is a hierarchy in the financial management obligations of the Act. The test of prudence sits at the top of this hierarchy. The financial strategy, funding and financial policies and observance of the balanced budget test are all subject to prudence.

Prudence involves acting carefully or with deliberation. In trustee law, prudence is also often defined to mean careful, but also taking advice from appropriately qualified people and acting in accord with industry norms. A prudent LTP must manage the financial consequences of policy, service delivery and funding decisions over the useful lives of assets, not just the ten years of the plan.

Your local authority must also meet the so-called 'balanced budget' test of *section 100* of the *Local Government Act*. Operating revenues must be set at a level sufficient to meet operating expenses unless your local authority considers that it is financially prudent not to balance the budget having had regard to future expenditure requirements, impacts on service levels, and equity between the current and future ratepayers. If you are running an unbalanced budget the burden of proving this is prudent lies with you. Operating a balanced budget does not necessarily demonstrate prudence in and of itself.

Financial Strategy

A financial strategy is both an overall direction for the financial 'side' of the LTP and a synthesis of the financial issues and consequences of your local authority's policy and service delivery decisions.

Your financial strategy is part of the content of an LTP – but is intended to factor in the way that your local authority manages the financials and makes policy and service delivery decisions with financial consequences.

Preparation of a financial strategy is now a mandatory part of an LTP, but was previously viewed as good practice. No local authority should have to start a strategy 'from scratch' – especially as so much of the financial direction is determined by your existing environment.

A financial strategy is more than just a series of limits on rates and debt. A robust financial strategy must be grounded in sustainability of service and therefore draws on (among other things) your asset information and activity management plans. A strategy that is not adequately reflected in activity plans will struggle to demonstrate prudence and will probably be frequently breached.

While the Act sets out some mandatory content for a financial strategy – your strategy will reflect issues and concerns that are specific to your local authority.

The impact of population change and land use change on operating and capital expenditure are mandatory disclosures – whether these are significant issues for your local authority or not. Likewise your strategy must disclose planned capital expenditure on network infrastructure and flood protection/control work and this will need to align with other disclosures.

There must be a quantified limit on rates, rates increases and debt – though what your limits are, and how you express these is a matter for local choice. Don't forget that your limits, and the rest of the strategy are subject to the test of prudence. Part of that will include explaining how the limits impact on your ability to maintain levels of service and meet new demands for services.

Your financial strategy is a key part of having the right debate with your community. The strategy should therefore be included among the key issues for presentation in your summary LTP, and sit alongside the other key issues in the main LTP.

Funding and Financial Policies

The Act requires preparation of a set of funding and financial policies – namely:

- revenue and financing policy
- liability management policy
- investment policy
- policies for remission and postponement of rates on Māori freehold land

- policy on development contributions and financial contributions
- remissions policy (required only if you want to remit rates on general land), and
- postponements policy (required only if you want to postpone rates on general land).

Funding and financial policies are an important part of the LTP – they help the community understand not only what they will be expected to pay, but how they pay and when they will pay.

Funding and financial policies cannot be developed in isolation from the two step funding process of *section 101(3)*. That process is a sequential two-step process. The first step includes consideration at activity level of the rationale for service delivery, beneficiary pays, exacerbator pays, intergenerational equity, and the costs and benefits of separate funding. Once the first step has been completed, consider the impacts on social, environmental, economic and cultural wellbeing of the entire set of results out of the first step.

The RFP is now the only *section 102* policy that must be included in the LTP. However an understanding of the other policies may aid some users so your local authority should consider at least including summaries of the other policies in your LTP.

While your RFP must show how your local authority complied with *section 101(3)* this does not necessarily mean a blow by blow account of all of the analysis that was undertaken. Common approaches may exist to funding activities that may offer opportunities for shorthand descriptors. If using this approach be sure to clearly define the descriptors and the circumstances in which they apply. And don't forget that the RFP must separately explain your selection of funding sources for operating and capital expenditure.

The strategic content of the borrowing management and investment policies has been moved to the financial strategy – these policies are now largely documents that describe how your local authority manages risk.

Having a policy that discusses remission and postponement of rates on Māori freehold land is a mandatory requirement. Your policy should flow out of your consideration of the objectives set out in *Schedule 11* of the Act, which may lead you to not remit and postpone rates on this land at all.

Financial Forecasting

Financial forecasting and modelling link your policy and service delivery choices to the financial "bottom line" (a set of forecast financial statements). Forecasting requires a set of forecasting assumptions and a tool for modelling (be it a software package or a spreadsheet).

An assumption is something that your local authority accepts as being true about the future. Most probably there will be two levels of assumptions – corporate level and activity level. Corporate level assumptions should be prepared (or reviewed) by the LTP project team as soon as possible after the LTP project begins. Your assumptions should be realistic, evidence based, internally consistent, and applied consistently.

Where assumptions involve a significant level of uncertainty then you need to disclose the uncertainty and the impact on the financials.

Your forecast financial statements will only be as good as the robustness of your assumptions and modelling tool. Your financial model will need good supporting documentation, good controls and be readily understandable to an outsider. It can be difficult to achieve this with spreadsheet based models.

If you need to implement a new system or modelling tool, its generally best to have the system bedded in by June of the year preceding the LTP.

Financial Statements

Financial information should integrate with the remainder of the LTP but should also be clear, transparent, robust, and balance level of detail and usefulness to the reader.

The Act requires two sets of financial information – the usual GAAP regulated statements of financial position, comprehensive income and the like, and a funding impact statement.

The funding impact statement (FIS) is exempt from the requirements of GAAP but must follow the formats prescribed in the Financial Disclosure regulations. These statements are meant to show only flows of funding and therefore exclude vested assets, revaluations and depreciation.

Your council-level FIS is one of the procedural requirements of the rate-setting process and sets out all of the mechanics of the rating system and some examples of the impact of the rating proposals. Defects in your FIS can invalidate any action taken in reliance on the FIS.

PART ONE: INTRODUCTION

1.1 What is this Guide?

This Guide has been written to help local authorities produce financial policies and practices that provide a useful basis for conducting the 'right debate' with their local community. It is not a complete guide on financial management and reporting for local government.

In this Guide you can expect to find the following:

- what financial strategy is and why its important
- preparing a useful financial strategy
- writing funding and financial policies that the community can understand
- financial forecasting (including reviewing your forecasting assumptions)
- preparing a useful funding impact statement.

1.2 What is 'Financial Management Under the *Local Government Act*'?

Financial management under the LGA goes wider than the traditional compilation and maintenance of financial information, reporting that information, and the day to day administration of revenues, expenses, assets and liabilities.

Financial management under the LGA encapsulates all of these duties but is also about:

- defining both a fiscal envelope for your local authority and who will be called on to contribute, and how
- using financial information as an input into your local authority's decisions on its package of service levels and policies and how they contribute to community wellbeing – decisions about one should be made with knowledge of the impact they have on the other. The term the Act uses to describe this, almost symbiotic relationship is *integrated decision-making*
- presenting this information to the community in a manner that they can fully participate in the process of making the tradeoffs between cost and levels of service. The in-vogue term for this is having *the right debate* with the community which is the second of the seven pillars of wisdom in long-term planning.

1.3 Principles

Good financial management under the LGA should be principle based. The following represent a set of principles that when observed, should provide for financial management that complies with the technical requirements, but is also a useful tool for meeting decision-making requirements and conducting the kind of community engagement envisaged by the LGA.

Principle One: Integration
Your local authority's financial policies and practices should support the overall package of service levels and policy decisions taken.

Financial policies and practices need to be consistent with, and add context to all of your local authority's decisions and actions (and vice versa). Financial decisions should be made with full knowledge of the implications that these have for service levels and vice versa (for example, when a decision is made to limit rates increases both elected members and the community must be made aware of the implications that decision has for levels of service).

Principle Two: Financial Sustainability
Financial management policies and practices need to be designed and operated in a way that delivers service to the agreed standard over the life of the asset.

Financial sustainability means that your financial policies and practices should be operated in such a way as to meet the current needs of the community without compromising the ability to meet future needs. This implies that:

- your financial policies and practices should ensure that the service levels indicated in the council's long-term plan are delivered (and to this extent this principle is strongly linked to the integration principle)
- adequate provision is made for assets across their useful lives
- your funding needs are managed in a way that is affordable over time, while maintaining intergenerational equity, and
- your financial policies and practices should ensure that your local authority maintains a sound financial footing with which to approach the future.

Principle Three: Robustness
Financial policies and practices need to be based on current and forecast financial and other information that is complete, accurate, and based on the best information about the future circumstances available to local authority.

Financial management requires a complete base of accurate information on the current situation that goes beyond the purely financial and includes asset information and service levels for non-asset activities. Robust financial management under the LGA requires not only complete forecasts of financial, asset and projected performance information but also requires the best information that the local authority has regarding its future operating environment such as:

- likely future changes in the policy environment (changes in environmental and other standards, new legislation etc)
- the local economy (price change, local labour market conditions, incomes in the district – which may necessitate taking a view on world conditions), and
- demographic change (patterns of population growth and decline, changes in the population structure and the like).

Principle Four: Clarity
Financials should be understandable to the 'reasonably informed' reader, and preferably be understandable to the 'person in the street'

This is one of the more difficult of the principles to achieve in practice as there is a tension between some of the GAAP requirements and how many people think of finance.

Principle Five: Transparency
As well as understanding the 'what', financial policies and practices, need also to demonstrate the 'why' and the 'how'.

The LGA is based on a notion that accountability to the community must be based on *what* your local authority is doing, but also why it is doing it. This holds equally true in financial management, and particularly so around the making of funding policy (where the requirements of *section 101(3)* in terms of the funding process and the documenting of this in the revenue and financing policy are essentially about showing people how the council arrived at funding decisions). It is not enough that your policies explain the 'what' they must also explain the 'why', for example why your local authority has a policy of going to the maximum on uniform charges.

1.4 How to Use This Guide

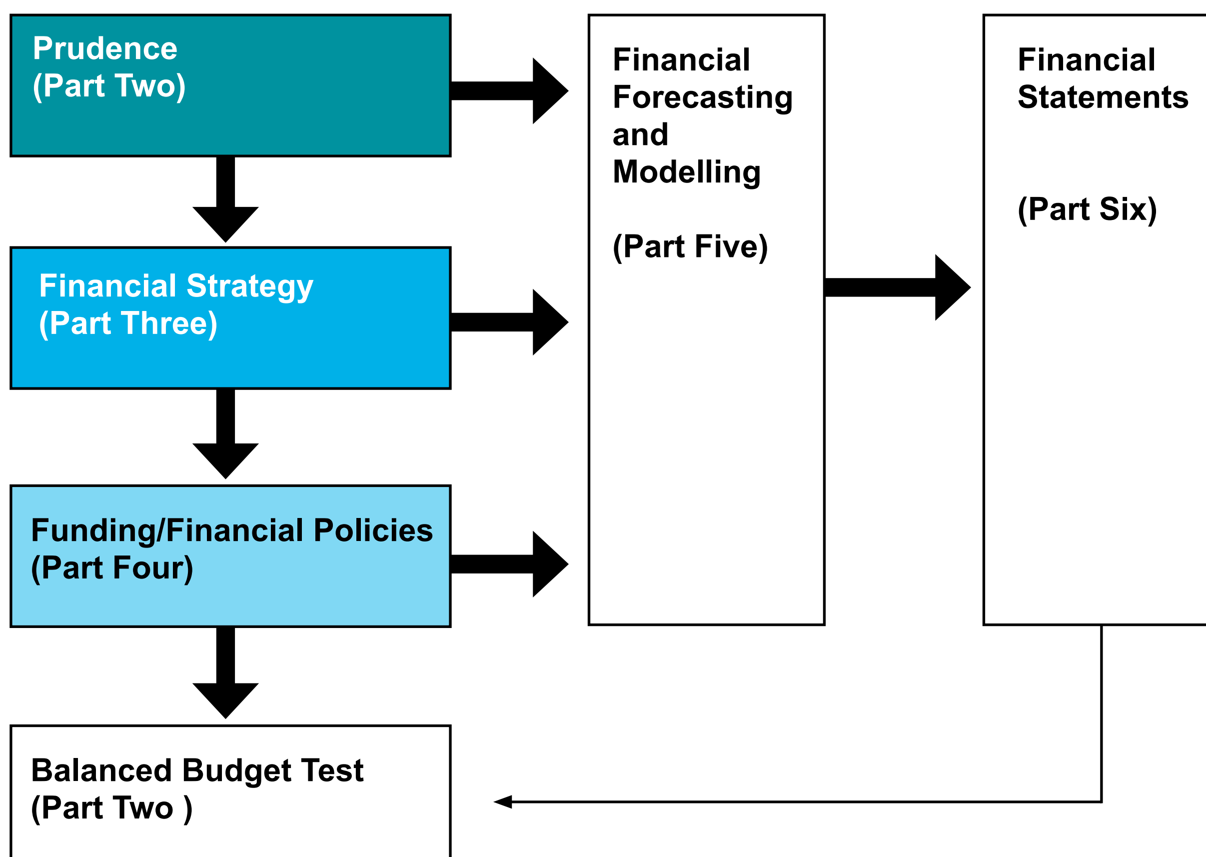
Figure 1.1 shows the basic framework for financial management under the *Local Government Act*, which will also serve as the overall roadmap for this Guide.

Readers will notice that the left-hand column of four boxes have been linked to each other by a series of arrows. These describe the hierarchy of financial management obligations under the Act, with the obligation to manage financials prudently sitting at the top of the hierarchy. As we move down the page and the shading of these boxes moves to lighter colours, we also move further down the hierarchy.

Each of Parts Two, Three and Four of this Guide discusses a different component of the hierarchy:

- Part Two discusses prudence in the financial context, and also discusses the balanced budget test as the two are closely linked.
- Part Three discusses the most significant of the requirements introduced in 2010 – that of the financial strategy. The single biggest concept to take from this guide is that of the importance of sustainable financial strategy not only in the LTP, but in the overall day to day governance and management of your local authority
- Part Four discusses each of the funding and financial policies of *section 102* of the Act.

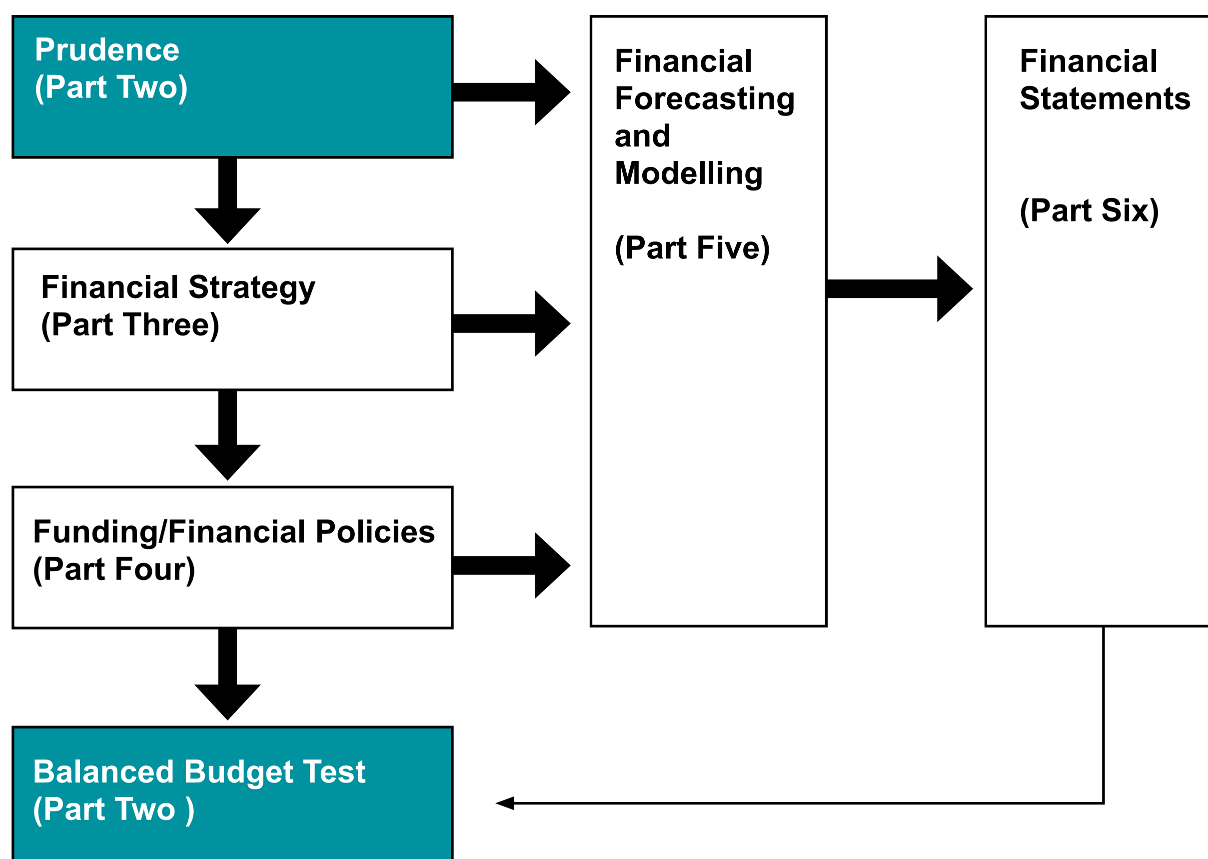
Figure 1.1 The Roadmap for this Guide



Your local authority's approach to prudence, its financial strategy, its policies and its asset and level of service information all feed into the development of a financial model. This model also relies on a series of forecasting assumptions covering events and circumstances external to your local authority. Part Five of the Guide discusses forecasting assumptions and building models.

The last part of the Guide deals with the preparation and production of financial information – including financial statements that are GAAP compliant and the funding impact statement as reframed in 2010.

PART TWO: PRUDENCE AND THE BALANCED BUDGET



In this first substantive part of the guide we briefly discuss the financial management obligations and how these fit together into a single hierarchy of financial management. This part of the Guide then turns to the top of the hierarchy and discusses the test of prudence and how it applies to all of your financial dealings. Towards the end of this part of the Guide we'll also discuss the bottom part of the hierarchy, the balanced budget test, and how the two tests interact.

2.1 The Hierarchy of Financial Management

The Act places four main financial obligations on local authorities, that is:

- financial management that is prudent and in the current and future interests of the community
- adoption of a financial strategy
- adoption of a set of funding and financial policies (including following a two step process when deciding how to fund your services and activities)
- balancing the budget.

These are shown in Figure 2.1 below. Broadly speaking, the four obligations form a hierarchy with the obligation of prudence sitting at the top. *All of the other obligations are subject to, and must demonstrate prudence.* That is to say, your financial strategy must be prudent, and your observance of the balanced budget test likewise – although in practice there is some degree of cross-checking between the four obligations.

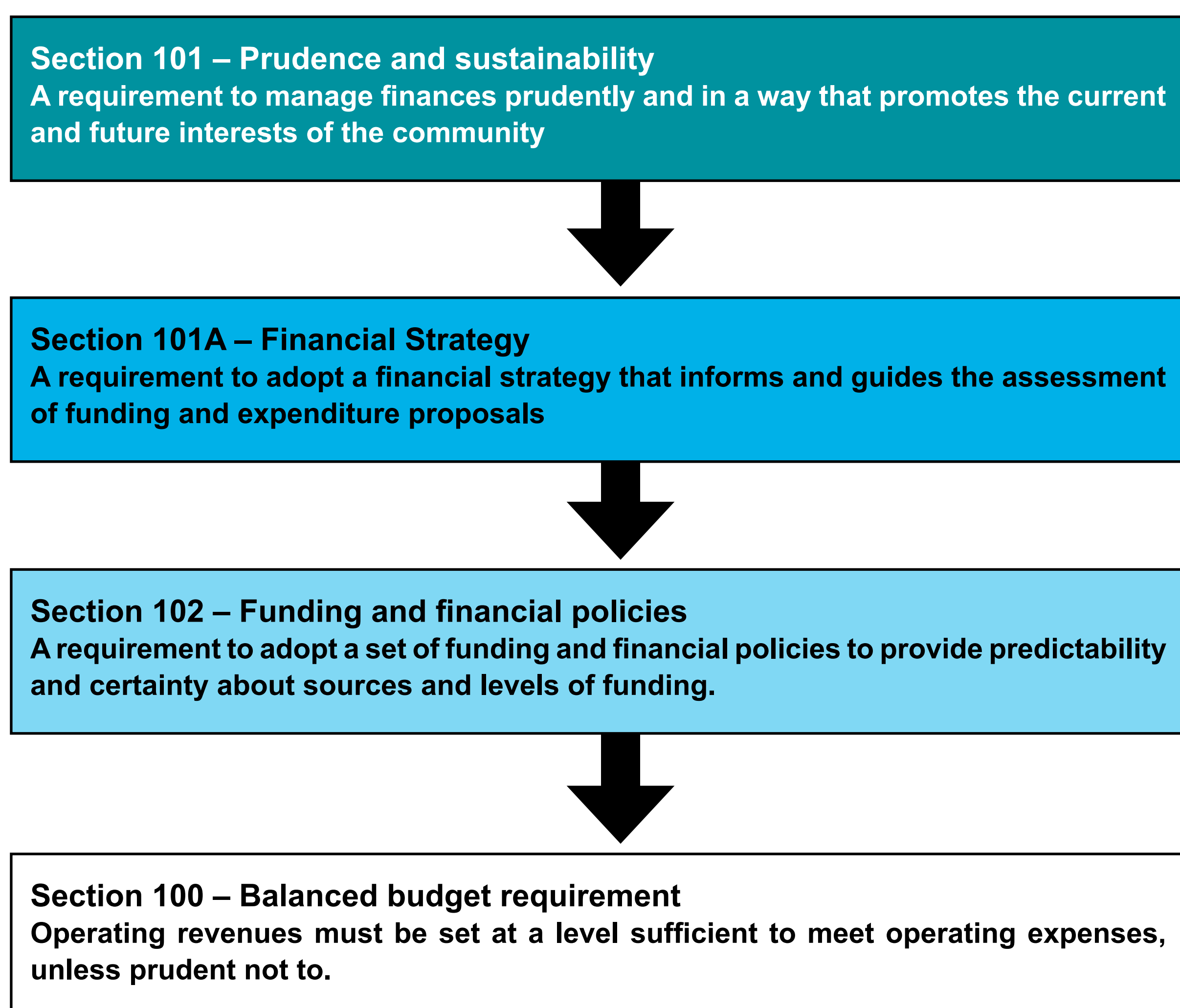
2.2 Prudence

Managing your financials prudently is not optional – *section 101(1)* and *(2)* of the Act set out that

(1) *A local authority must manage its revenues, expenses, assets, liabilities, investments and general financial dealings prudently and in a manner that promotes the current and future interests of the community.*

(2) *A local authority must make adequate and effective provision in its long-term council community plan, and its annual plan (where applicable) to meet the expenditure needs of the local authority identified in that long-term council community plan and annual plan.*

Figure 2.1 The Financial Management Obligations



The Act does not contain a definition of financial prudence – so what does being "financially prudent" actually mean? In the standard dictionary sense, prudence means 'careful', 'sensible', or 'habit of acting with careful deliberation'. In trustee law, prudence is also often defined to mean careful, but also taking advice from appropriately qualified people and acting in accord with market (in this case industry) norms.

Section 101 of the Act must also be interpreted in the light of *section 100* (the so-called 'balanced budget' requirement). This reads:

(1) A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses.

(2) Despite subsection (1) a local authority may set projected operating revenues at a different level, if the local authority resolves that it is financially prudent to do so, having regard to
- *(a) the estimated expenses of achieving and maintaining the predicted levels of service provision set out in the LTP, including the estimated expenses of achieving and maintaining the service capacity and integrity of assets throughout their useful life, and*
- *(b) the projected revenue available to fund that estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life, and*
- *(c) the equitable allocation of responsibility for funding the provision and maintenance of assets and facilities throughout their useful life, and*
- *(d) the funding and financial policies adopted under section 102.*

There is one other statutory reference that indicates Parliament's view as to what is financially prudent. The legislative rationale for the *section 102* policies is 'in order to provide predictability and certainty about sources and levels of funding' – suggesting that predictability and certainty of funding levels and sources is an element of being financially prudent.

Prudence as a test:
- is a matter of legal compliance and thus falls within the mandate of the auditor
- requires consideration of the current and future interests of the community (in other words, prudence is more than just holding next year's rates increase to inflation)
- applies across the useful lives of assets – not just the three years of the current triennium, or even the ten year life of the current LTP. This means that your auditor will be looking at asset and financial information beyond the LTP, especially where there are doubts about the overall prudence of your financial strategy
- has precedence over the balanced budget requirements of *section 100* – that is to say, that the fact of a balanced budget is by no means determinative of a prudent approach to financial management (more on this later)

Prudent financial management is more than just a balancing of the books, although that may well be an important part of your demonstration of prudence. It is the linking of your overall financial strategy to your service/asset strategies and other policy choices so that each decision is made in the light of each other and in a way that all are sustainable.

Assessing Prudence

The following questions might be useful when assessing the overall prudence of your plan:

- have you taken account of funding requirements over the useful life of your assets (robust asset management plans will be needed to fulfil this requirement) or is there a "bulge" in needs in "year 11"
- what analysis (if any) has the council done on the affordability[11] of the demands it is making on the community both now and in the future (for example has the council considered whether growth in rates is matched by growth in incomes)
- what are the reasons for any surpluses or deficits forecast in the plan
- are the financial parameters in your LTP realistically achievable – for example will your local authority be able to obtain borrowing in the amounts indicated in your plan
- has adequate account been taken of the levels of risk associated with some of the forecasting assumptions – for example what happens if the economy contracts and development slows
- has the right balance been struck between the interests of the current and future community
- what are the reasons for "hits" in the council's financial position (such as draw-downs on reserves) and is there a recovery strategy (and if not, should there be).

Box 2.1 shows a real-life case study that shows how the assessment of prudence was performed during one local authority's long-term planning process.

Box 2.1: A Case Study - Waitomo District Council's 2006-16 Plan[2]

In 2006-16 Waitomo District Council received an adverse audit option on both the LTP statement of proposal and the final LTP on grounds that the financial strategy was not financially sustainable, and therefore not prudent.

The then council and auditors considered that the Council had an aging and failing stock of infrastructure and was faced with a significant amount of capital work to maintain services at their levels at the time.

The true position was clearly communicated to the community in the LTP statement of proposal. That statement signalled the need for ratepayers to bear a substantial and increased burden of the costs.

The LTP statement of proposal set out six alternatives that Waitomo had considered. The council's preferred option involved a considerable degree of borrowing over the life of the plan. That option saw debt increase from $29 million to $69 million over the life of the plan - while rates increased from $9.2 million to $15.3 million. By 2016 the council was forecasting that interest costs would account for about a third of total rate revenue. The council also relied heavily on dividend revenue from a subsidiary (Inframax).

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[1] We use the term affordability in the sense that refers to ratepayers ability to pay, often elected members and the public use the term "unaffordable" when what they are really referring to is their willingness to pay or to approve an increase in rates.

[2] Adapted from OAG (2007), Matters Arising from the 2006-16 Long-term Council Community Plans and Waitomo District Council's 2006-16 LTP.

OAG's qualification centred around the sustainability of the financial strategy. OAG did not find sufficient assurance that revenue was available to meet both operating and capital needs – while the operating budget was in surplus this did not necessarily indicate a strong financial position. The increase in debt was substantial, and of such a level that the auditors had concerns about the council's ability to borrow to a level substantially higher than industry norms. The council's forecast information for years beyond the plan suggested that debt levels were unlikely to reduce.

As a result of this process, the then Government established an advisory panel[3] to help Waitomo improve its financial management, governance and asset management and to help the council understand the funding choices it had before it. This process helped the council review its choices to the point where the 2009 LTP opinion was not adverse, though the auditors did draw the ratepayer's attention to the central position that dividend streams from Inframax had for the financial strategy in the later years of the plan.

In short, lessons to be taken from this are:

- failure to manage the financials prudently can have serious consequences
- balancing the operating budget does not guarantee in and of itself that your financial strategy is prudent
- the test applies over the useful lives of assets not just the LTP period.

2.3 The Balanced Budget Requirement

The balanced budget requirements of *section 100* of the LGA are one of the most misunderstood and misapplied concepts in local government administration. The balanced budget test is conducted firstly at the local authority level – not at the level of particular activities or groups of activities. Auditors may look at surpluses and deficits in particular activities in forming a view about the prudence of an unbalanced budget.

What the Act does is create a rebuttable presumption that showing a small surplus is financially prudent. However, running a surplus in and of itself may not always demonstrate prudence, as there are a number of circumstances where the receipt of revenue and incurring of expenses will differ.

It is conceivable that running a substantial surplus could be imprudent. For example, such a strategy might be creating intergenerational inequity in that the current generation are expected to meet a disproportionately high share of costs. Your reasons for creating substantial surpluses, and the consequences of that surplus, should be recognised in your financial strategy just as reasons for conducting an operating deficit would be.

This test is sometimes (incorrectly) called the "funding of depreciation" clause. In fact, there is no direct legal requirement to "fund" depreciation. The confusion arises because local authorities are required to set operating revenues at a level sufficient to meet operating expenses, and because *section 111* obliges you to follow GAAP, you must follow the GAAP definition of 'operating revenue' and 'operating expenses'.

[3] Note that this was a non-statutory intervention – not a review panel under *section 254* of the Act.

What the legislation requires is that councils ensure that revenues are set at a level that is at least equal to operational expenditure (including depreciation), unless it is prudent to do otherwise. There is no requirement to set money aside in 'jam-jars'. Funding may be used for present capital needs (including renewals), debt reduction or set aside for future capital needs. This helps ensure sound asset management practice and continuity of service to future generations.

Exceptions to the Balanced Budget Requirement

The LGA provides local authorities with a set of exceptions where they may depart from the requirements of the balanced budget. These exceptions do not provide a licence for any local authority to depart at will from the balanced budget. They require careful thought and analysis of your funding needs and overall financial strategy. Box 2.2 provides a case study of the type of analysis that local authorities that want to use these exceptions must perform.

A decision to make use of the exemptions will require a council resolution that it is financially prudent to set operating revenues at a level different from operating expenses. In other words, not meeting the balanced budget test is a *conscious policy decision* by elected members having full information on the consequences, and having had regard to *each of the following*:
- the cost of *achieving and maintaining* the planned levels of service
- maintaining service capacity and integrity of assets over their useful life
- equitable allocation of costs (both now and in the future, and between different ratepayers), and
- compliance with Council funding and financing policies (established under *section 102*).

These provisions create an opportunity for local authorities to consider their funding requirements from an economic sustainability perspective, rather than the accounting perspective which is presented in the forecast financial statements.

The key elements of the exception provisions are therefore:
- prudence
- the obligation to have regard to
- service levels
- useful lives
- your *section 102* policies, and
- equitable allocation.

Prudence

The GAAP based forecast financial statements are the starting point of any local authority's consideration of the balanced budget requirement of *section 100*. However, in situations where the timing of recognition of an item of revenue or expense for financial reporting purposes differs from any associated cash flows, a local authority may set the level of rates funding at a level different from that which would achieve a balanced budget. For example, your local authority might decide to utilise reserves built up in prior years to fund an operating deficit in any year or years within an LTP. In effect these reserves have been built up from operating surpluses in previous years and therefore it is reasonable to utilise such funding in subsequent years if such use is consistent with Council's revenue and financing policies.

Box 2.2 Determining the Prudence of an Unbalanced Budget – Porirua City

This local authority adopted a 2009-19 LTP that forecasts operating deficits in each of the first seven years of the life of the plan. In its 2006-16 LTP the council ran operating deficits in each year of the LTP.

The 2006 LTP noted Porirua is a relatively "new" community with much of the core infrastructure having been built between 1950 and 1975. Based on asset planning the council estimates that its "three waters" infrastructure is unlikely to require significant renewal work until 2025 (at the earliest). Improvements in asset information (particular in the water infrastructure) between 2006 and 2009 convinced the council that it is was prudent to move to a balanced budget.

In explaining its approach the council drew on its asset information which (among other things) contains detailed projections of renewal requirements to the year 2059 for its "three waters" infrastructure. Summaries of the asset information were included alongside the financial strategy.[4]

In addition to this disclosure both the financial strategy and the Chief Executive's summary noted that the policy decision was for a transition towards a balanced budget. These disclosures also:

- emphasised that the council had sufficient funds to provide for the planned service levels
- council was looking at the causes of degradation of their assets and managing these with a view to lengthening replacement cycles
- operating deficits are not cash deficits
- borrowing sat well within the council's limits (and industry norms)
- emphasised that there was a peak of renewals in wastewater from 2019 and linked this back to the strategy for funding.

Auditors considered the main risk of the approach is to intergenerational equity. In particular the 2006 audit highlighted that while revenue would be sufficient to maintain levels of service, there would be reasonably substantial increases in rates in the future (and these would be higher than if the council had run a balanced budget in its 2006-16 plan).

In both 2006 and 2009 the Auditors added explanatory paragraphs to the council's audit opinion that drew the attention to the unbalanced budget, and the importance of the consequences of not balancing the budget in assessing the LTP.

Having Regard To …

There is case law which deals with the phrase ' have regard to'. Basically the cases suggest that where your local authority is required to have regard to some matter, the obligation is only to consider the matter[5]. New Zealand case law holds that the phrase 'have regard to' is not synonymous with 'shall take into account' or 'give effect to'[6]. How your local authority considers the matter and what weight, if any, you attach to the matter is a policy decision.

[4] Readers interested in this information should refer to Porirua City Council (2009) pages 43-50.
[5] See R vs CD (1976) and Bleakley vs Environmental Risk Management Authority (2001) for further discussion of this point.
[6] Refer to Unison Networks Ltd vs Hastings District Council (2007), Foodstuffs (South Island) Ltd vs Christchurch City Council (1999) and Sanford Ltd vs New Zealand Recreational Fishing Council Inc (2008).

If your local authority resolves not to operate a balanced budget in any of the years covered by the LTP, it will be required to include a statement in the LTP explaining:

- why the budget will not be balanced – explained in terms of the *section 100(2)* matters and any other matters that were taken into account
- the implications of the decision – which includes not only the service level and other policy consequences, but also any identified effects on the social, environmental, economic and cultural well-being of the community.

In short, the service level and other operational consequences of a decision not to balance the operating budget cannot be 'hidden' but must be exposed for public consultation.

Levels of Service

Schedule 10 requires disclosure of the intended levels of service and the estimated expenses of maintaining those levels of service, including those expenses associated with maintaining the service capacity and integrity of assets. The requirement to consider levels of service ensures that elected members understand the effect that any decisions they make may have on meeting the levels of service, and that if the result will undermine levels of service that this is disclosed to the public.

The obvious, and commonly used example of the kind of result this consideration may give is the community hall in a 'depopulating area'. Often the local community has no desire to see the hall maintained to current levels of service. In those cases the amount of funding for future needs would be determined by the service levels of the future, not the present, and the level of funding could be reduced. Again though, this is a decision that should be taken in consultation with the community!

Useful Lives

This is essentially further statutory recognition of the concept of intergenerational equity. If depreciation is a means of ensuring today's ratepayers meet the cost of their 'consumption' of the asset, then considering useful lives effectively reminds decision-makers of the period over which the consumption occurs.

Equitable Allocation

This phrase is also not defined in the Act. However, in the context of the legislation the equity should be viewed as addressing equity amongst groups currently within the community and between current and future community members.

The Act requires that you consider the pattern of costs to be incurred now and in the future to maintain a specified level of service, and to ensure these costs are forecast to be met by those members in the community that will receive the service (either directly or indirectly). The core question when considering a forecast operating deficit is whether current ratepayers are paying an appropriate level of rates bearing in mind the services they are receiving. This will typically involve deeper analysis of the apparent position to identify whether, for example, the deficit arises from a mismatch between the period in which expenses and revenues are recognised in terms of GAAP.

The phrase equitable allocation of costs also implies consideration of the likely burden on different ratepayers. For example, running surpluses in some activities and deficits in others may mean that the users or beneficiaries of one activity may be meeting a disproportionate share of costs relative to others.

Funding and Financial Policies
An unbalanced budget should also be tested against your *section 102* policies – especially the revenue and financing policy and the liability management policy. For example, if funding from reserves is used, then does your revenue and financing policy allow for this?

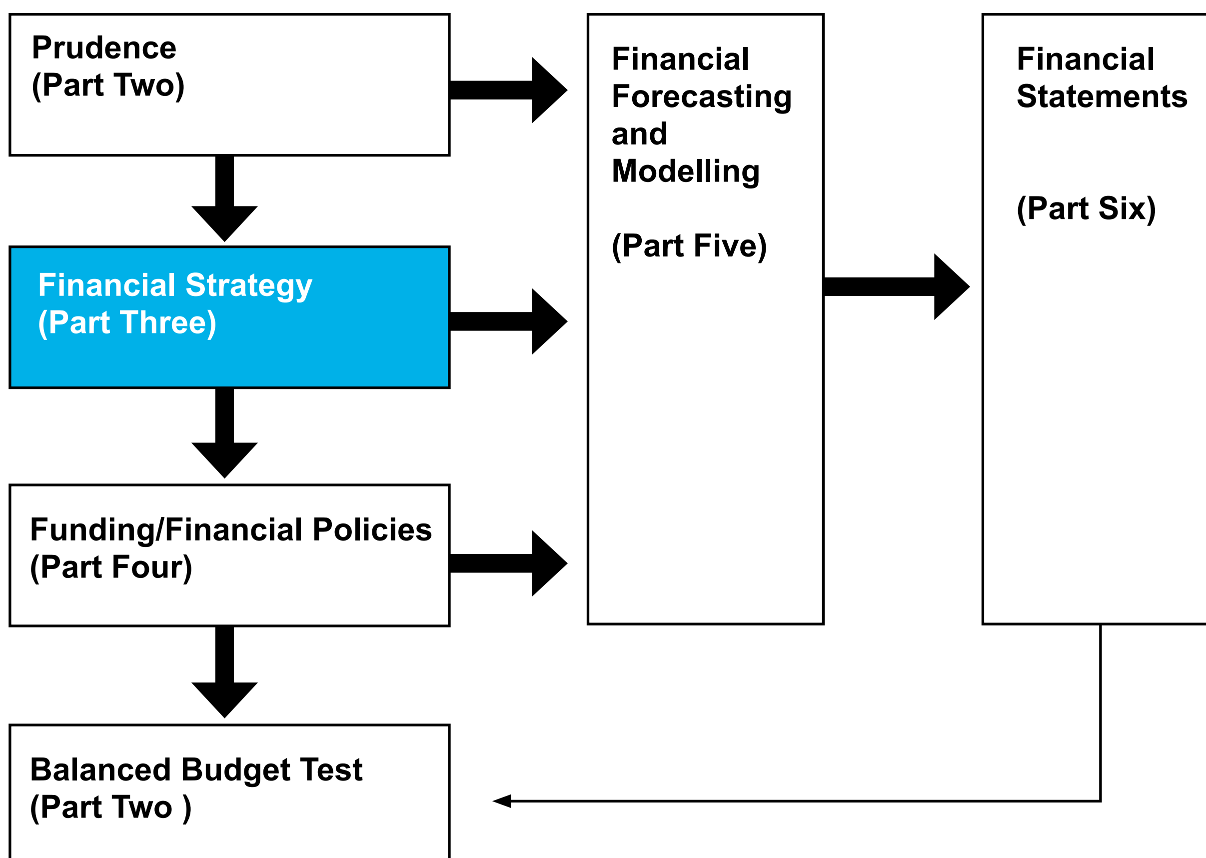
Things to Remember: Prudence and the Balanced Budget

1. There is a hierarchy in the financial management obligations of the Act. The test of prudence sits at the top of this hierarchy. The financial strategy, funding and financial policies and observance of the balanced budget test are all subject to prudence.

2. Prudence is the key legal (and audit) test of your financial management. A prudent LTP must manage the financial consequences of policy, service delivery and funding decisions over the useful lives of assets, not just the ten years of the plan.

3. Your local authority must also meet the so-called 'balanced budget' test of *section 100* of the *Local Government Act*. Operating revenues must be set at a level sufficient to meet operating expenses unless your local authority considers that it is financially prudent not to balance the budget having had regard to future expenditure requirements, impacts on service levels, and equity between the current and future ratepayers. Operating a balanced budget does not necessarily demonstrate prudence in and of itself.

PART THREE: FINANCIAL STRATEGY



This part of the Guide discusses the most important of the financial contents of the LTP, your local authority's financial strategy. While the legislative changes made a financial strategy a mandatory part of an LTP, your financial strategy is a key 'right debate' issue that sat, or should have sat in previous LTPs. In this section you can expect to find out:

- what a financial strategy is, and what a financial strategy does
- what must go into a financial strategy, and how to decide what else should be included in your strategy
- how to prepare a sensible strategy.

3.1 What is a Financial Strategy?

A financial strategy is both:

- an overall direction for the financial 'side' of the LTP which is arrived at in a 'top down' fashion (as opposed to arriving at the forecast financial consequences by aggregating separate sets of numbers from each activity) and
- a synthesis of the financial issues and consequences arising from your local authority's policy and service decisions. The overall direction for the financials must be grounded in your local authority's current situation and the direction the other parts of the LTP take.

In effect, the financial strategy is the financial part of the overall story that your LTP tells the community. That link between the financial and non-financial parts of the strategy means that your strategy is a key 'right debate' issue.

Your financial strategy must be rooted in an understanding of your specific issues and drivers – financial strategy is not something that can be copied from others, nor can a template exist. A local authority with assets that are coming to the end of their useful lives and which is undertaking significant renewal expenditure will probably have a completely different financial strategy than those which are creating new assets for growth or have relatively new infrastructure.

Section 101A of the Act establishes that the purpose of a financial strategy is to facilitate:

(a) prudent financial management by (your) local authority by providing a guide for local authorities to consider proposals for funding and expenditure against; and

(b) consultation on the local authority's proposals for funding and expenditure by making transparent the overall effects of those proposals on the local authority's services, rates, debt and investments.

Box 3.1 shows what can happen if your local authority approaches the LTP without a financial strategy.

Box 3.1: A Financial Strategy Gone AWOL - A Cautionary Tale

Kiwi District Council is a provincial authority[7]. The Chief Executive considered that activity managers needed to own their performance – including both financial and non-financial. All activity managers prepared full financial information in their plans – the finance team checked the forecasts and compiled them into a single model. No officer undertook a "stand back" test – the council financials were merely aggregated from the activity plans.

The first full version of the plan highlighted a major flaw in the process – Kiwi's financials showed it planned to double both its rates and debt over ten years, while accumulating significant cash reserves.

This lack of an overall financial strategy was detected as an issue during the audit process. Resolving it meant going back to activity and asset plans and rebuilding the LTP almost "from scratch". Having some parameters set before these plans are finalised give managers a guide on what levels of service they can set, and what limitations might be placed on their ability to fund them.

Your strategy will become one of the tools your local authority uses in day to day governance and management (this is why the financial strategy is placed alongside the principles of financial management in the legislation). Application of the prudence test also means that the financial strategy will need to take account of financial needs outside of the period of the LTP – in other words rates cannot be set at an artificially low level in the strategy while a bow-wave of expenditure is pushed to 'year 11'.

Many in your community will focus on one particular aspect of the financial strategy – the limits on rates and debt. But a financial strategy is more than a set of numbers plucked from thin air.

A good financial strategy draws together all of the issues with financial consequences, presents these issues and the council's response, in such a way that the public can readily identify what the key financial issues are, what the main drivers of councils expenditure will be and how these all relate to the 'sharp end' of the strategy. A financial strategy is a communication challenge and not just an accountant's responsibility.

[7] This is based on a real local authority's 2006 LTP. While a financial strategy was not a legal requirement at that time, the real message is that without some degree of top down oversight, unintended consequences are likely.

3.2 Content of a Financial Strategy

A financial strategy should identify and explain the financial aspects of the council's overall direction, and explain why this is the direction, and how the council intends to get to that state of affairs.

By law, your strategy must include information about the council's desired end results or objectives – particularly the following:

- *a statement of your local authority's quantified limits on rates, rates increases and borrowing* and *an assessment of your local authority's ability to maintain existing levels of service and meet additional demands for service within those limits.* Box 3.2 further explains the limits on rates and debt
- quantified targets for returns on financial investments and equity securities (how you set those targets are up to you – but they must be quantifiable, and don't forget that your pre-election report must report against these targets).

Box 3.2: Explaining the Limits on Rates and Debt

What are the limits on rates and debt? To clear up some potential misconceptions:

- the limits on rates, rates increases and debt are not set by central government – each local authority must set its own limits
- your strategy must contain limits on rates, rates increases and debt – while the limits themselves are a policy decision, setting limits is not optional
- limits are not "set in stone" – your local authority can go beyond the limits if it wishes. But don't forget that your pre-election report must disclose whether or not your local authority complied with the limits
- limits must be quantifiable – for example, a limit on debt might be expressed as an absolute dollar amount, a prudential ratio such as debt/assets or interest as a percentage of total revenue, or similar but a statement such as *"debt will be maintained at a level consistent with intergenerational equity"* will not comply (and would also be difficult to report against).

And don't forget that you need to explain how these limits impact on your ability to meet current levels of service and future demands. The implications of limits need close examination – and that examination will require sound asset planning.

Other mandatory requirements are more background or contextual information. These are factors that you anticipate will have a significant impact on your local authority over the life of your strategy. Mandatory disclosures include:

- expected changes in population and land-use and the capital and operating costs of providing for those changes
- expected capital infrastructure on network infrastructure (as defined in *section 197* of the *Local Government Act*), flood protection and flood control works that is required to *maintain existing levels* of service that your local authority currently provides (the Act does not tie this disclosure to the expenses involved in achieving *planned* levels of service, this might be one of the "other significant factors" that gets disclosed in your strategy).

Your strategy must also disclose any other factor that affects your local authority's ability to maintain existing levels of service and meet additional demands for service[8]. The additional factors that get disclosed in your strategy should help explain your strategy and aid the readers understanding. Determining these factors and deciding how best to present these in your strategy will provide the biggest presentational challenge in your LTP. Expect to be called on to justify your selection of factors both during the audit process and during engagement on the LTP.

A third group of requirements involve some of the more strategic aspects of your treasury operation. These are:

- a statement of your local authority's objectives and targets for holding and managing financial investments and equity securities (the requirement is to disclose objectives and targets for each category of investment, not each individual investment)
- your local authority's policies on giving securities on its borrowing.

3.3 Preparing a Financial Strategy

The *Local Government Act* does not set out any particular procedural requirements for preparing the financial strategy – other than it must be included in the LTP and is therefore subject to the special consultative procedure.

Like the LTP itself, a financial strategy involves the successful marriage of both top-down elements (strategic direction and policy decisions) with bottom-up imperatives (level of service reviews and the associated asset/activity planning).

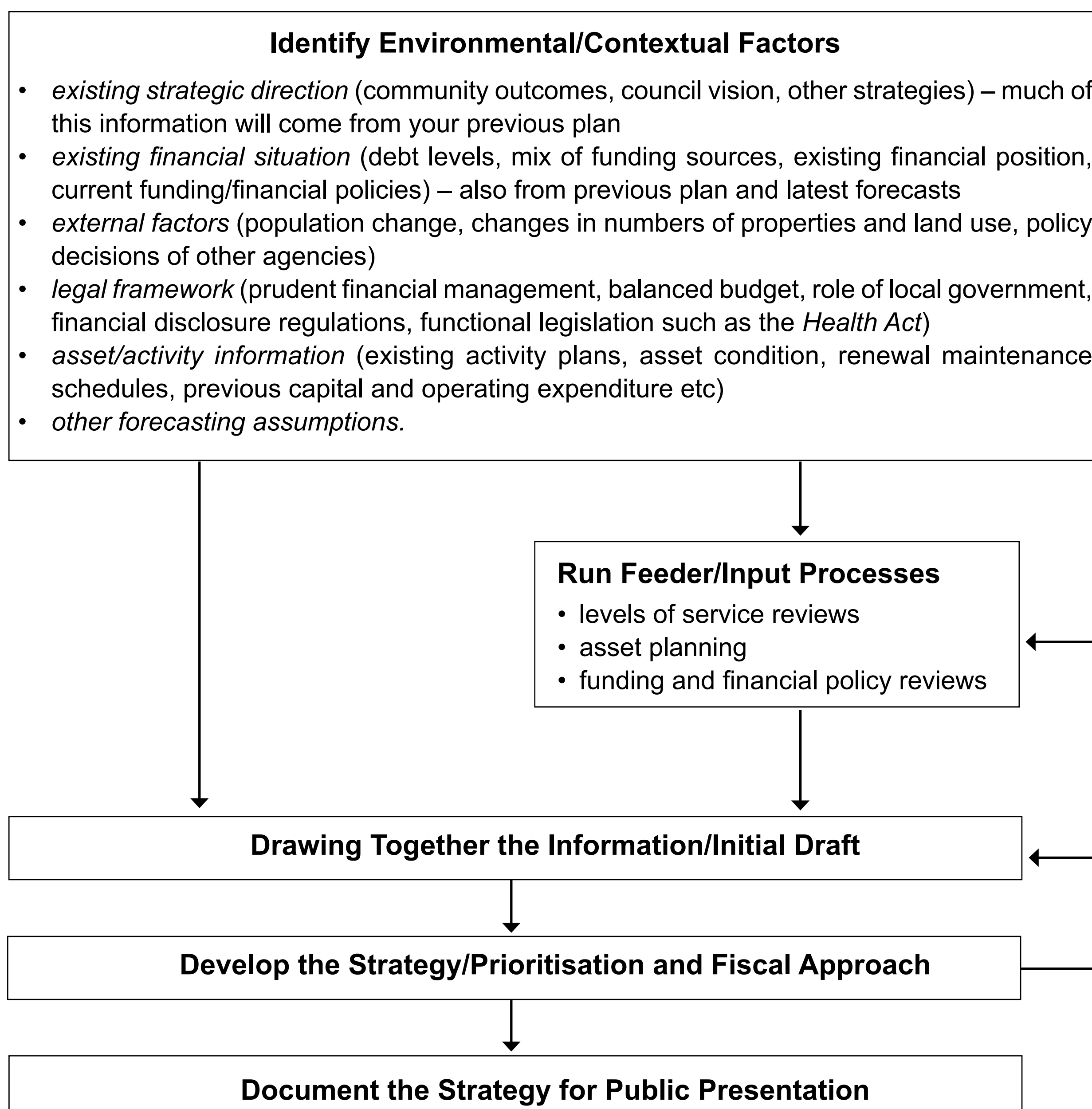
A robust financial strategy should not start with determining limits on rates and debt in isolation from all the other inputs. Starting from this basis automatically places restrictions on the LTP process and de facto makes your strategic direction a financially focussed one i.e. the default setting for level of services reviews is to hold levels of service (at best) or cut. *Robust financial strategy supports and underpins the other components of your LTP.*

Delaying a financial strategy until the completion of the remainder of the LTP means that your financial strategy becomes little more than an aggregate of the numbers in activity plans (as occurred in Box 3.1). Communicating the strategy to the community is difficult because there is no underpinning story, the opportunity to use the strategy as a tool for prioritising is compromised.

Preparation of a financial strategy is an iterative process – and while there are no hard and fast rules for the actual process, a process similar to that shown in Figure 3.1 should give successful results.

[8] The way the Act is constructed makes it more complicated for local authorities that wish to reduce levels of service – where levels of service are to reduce you will need to treat material differences as a factor in their own right.

Figure 3.1 Preparing a Financial Strategy



3.3.1. Identify environmental/contextual factors

Councils rarely start any part of the LTP process with a completely 'clean slate' – past decisions can limit or even dictate what decisions can be taken in the present. Preparation of a financial strategy begins by gathering environmental and contextual information necessary. Much of the information should be readily to hand so this should be a reasonably short, informal phase of work. In particular your financial strategy will need:

- *strategic direction* – other guides in this suite have emphasised the need to determine your local authority's strategic direction at an early point in the process. What are your local authority's community outcomes, and are there any other objectives of a strategic nature. Other plans and strategies, both statutory and non-statutory, may also be relevant

- *the existing financial situation* - such as debt levels, the mix of funding sources, and the existing financial projections as you start the LTP. What funding and financial policies do you start the process with? What is your existing financial situation and what constraints does that place on your strategy (for example is that council at prudential debt limits and need a debt repayment element to the strategy)
- *the legislative framework* – requirements such as *section 101* test of prudence, and the *section 100* 'balanced budget' test shape your approach to managing financial issues, functional legislation may have added or subtracted responsibilities to your mix of services. This also may be an appropriate time to check that regulations such as the LGA Financial Disclosure Regulations have not changed
- *levels of service and asset/activity information* - while the review of levels of service and the asset/activity information necessary to support that is a key part of the planning process, your financial strategy needs to be underpinned with an understanding of the following:
  - current and projected future levels of service (at least those based on the current LTP and the associated asset/activity management plans)
  - asset condition
  - capital, renewals, and maintenance schedules (and don't forget that capital now must be separated into capital to support growth, and capital that is to generate a level of service improvement)
- *external factors* – what factors outside of your local authority will impact on the financial aspects of your LTP? These might include the following:
  - changes in population levels or composition (a growing population poses one set of challenges, while a population that is static in terms of overall numbers but is "aging" might pose an entirely different set of challenges)
  - economic growth
  - other assumptions about developments in the economy (such as projected price change, forecast interest rates on investments and for borrowings)
  - land use change
  - policy settings/decisions from outside agencies e.g. has NZTA changed the types of transport expenditure it intends to fund.

    Many of these are likely to feature in your list of forecasting assumptions.

Involving elected members

Most of this information is generated through other processes and will be placed in front of elected members for their decision or noting as part of the process. In particular:

- decisions on strategic direction will have been made as part of the community outcomes process or in some other form of visioning exercise (more information on these can be found in *Performance Management: Still Your Side of the Deal*)
- elected members should briefly be reminded of the legal obligations
- elected members may need a refresher on the key level of service and asset issues, and key features of the funding and financial policies
- external factors will have been introduced to elected members in a paper for noting as these form the basis for your forecasting assumptions.

At this point in the process the concept of financial strategy could be introduced to the elected members, but at this point try to keep the discussion on the requirements and the process rather than seeking decisions.

3.3.2 Input/Feeder Processes

These processes have been labelled as input/feeder processes but in fact they both provide input to and are ultimately shaped by the financial strategy. They are an input in that some base knowledge of levels of service and future asset needs will ground the strategy in sustainability of service. They are shaped by the strategy in the sense that once the parameters are set there is some degree of iterative review of levels of service. These feeder processes are very much the 'bread and butter' of the LTP in that these processes account for (or should account for) much of the time and effort.

These include:

- *level of service reviews* (or at least the components of these that are internal to your council)
- *reviews of funding and financial policies*
- *asset/activity planning* – ensuring that all asset information is complete and up to date to ensure the asset and financial consequences of level of service reviews and the business as usual scenarios are well understood.

Most of the so-called "right debate" issues will emerge from these processes – many of which become significant factors to disclose in the financial strategy.

The objective with each of these processes is to ensure that issues and options have been identified and that officers have the information and analysis necessary to support the next stages of the process. This will include some preferred options for levels of service (and some alternative) and at least a rudimentary understanding of the financial consequences of each. It will also include either an understanding that funding and financial policies are robust, or some recommendations for change and the analysis to support those recommendations.

Involving Elected Members

While we have termed these as 'feeder' processes, each of these three sets of processes involve policy decisions at some point be it making a decision to constrain a level of service review to particular activities or establishing parameter for reviews of the funding and financial policy (such as establishing that the valuation base for the general rate will not change).

3.3.3 Drawing the Information Together

Once all of the contextual information is available and the feeder processes have been completed, information can be drawn together into a series of draft activity plans and other policies. At this point forecast financial statements based on the officers preferred options should be prepared.

This step of the process also provides a good opportunity to undertake some "what if" analysis on a few well-chosen alternative scenarios. Doing this analysis at this point can help:

- lighten the workload necessary to identify the impact of changes in direction and other tradeoffs later in the process
- highlight areas of risk (which has a payoff when you come to prepare the disclosures around the sensitivity of your forecasting assumptions)
- test the prudence of your financial strategy.

Involving the Elected Members

This is largely a technical phase of the process drawing together, among other things, the results of elected members inputs at earlier stages. You might seek views on what some of the alternative scenarios are.

3.3.4 Develop the Strategy (aka Prioritisation and Fiscal Choice)

Having drawn together all of the background information about activities and policies, your local authority can then begin the actual development of the strategy.

Step One: Consider the Overall Picture

This step requires consideration of the financial impact of the choices made and how this falls across activities, across different groups within the community and over time (for example – do the financials indicate significant swings in funding needs from year to year such as little rates increase in year one, and a significant increase in year two).

At this point officers should have a solid understanding of the drivers of cost, and be able to answer the following questions:

- what expenditure is associated with meeting legal requirements (e.g. drinking water standards, processing times for resource and building consents etc).
- what expenditure is irrevocably committed (such as projects that have already been started or expenditure that is irreversible for other reasons)
- what expenditure is essential (and why has this been deemed essential?)
- what expenditure is needed to maintain existing levels of service or meet the needs of population growth
- what expenditure is necessary to meet any planned increases in levels of service.

You should also have a good understanding of the funding implications:

- what is the level of rate revenue required to meet the above needs and how does the incidence of rates fall across the community
- what level of non-rate revenue required? Have you explored all alternatives (and if not what is the reason for this)? There is no legal requirement to place limits on these in the financial strategy
- what movements in debt occur – has the right intergenerational balance been struck?
- is the mix of funding sources consistent with the funding and financial policies (and if not, how do the policies need to change).

Step Two: Develop the Desired "Tracks" For Rates and Debt

At this point sensible discussions can be held to generate the 'top down' element of the strategy. The objective of this discussion is to generate elected member's "most preferred" future rate and debt requirements across the ten years of the LTP.

Those that prepared the better strategies in previous years tend to go into these discussions with some-form of presentation tool that can be used to illustrate the impact of different choices in real time – i.e a model and supporting graphics. This gives elected members an understanding that, for example, one of the consequences of a decision to hold rates to x percent in the first year of the plan without looking at levels of service might be an increase in debt from the second year of the plan, or the creation of a 'bow-wave' effect on rates in the latter years.

Step Three: Determine the gap between the desired tracks and those that came from the previous steps

It is unlikely that the elected members preferred "tracks" will exactly match those generated in previous steps of the process. The outcome of this step of the process is an understanding of the differences between the two sets of tracks (e.g. is the rates track lower 'across the board' or just in some years).

Step Four: Develop options for closing the gap

This step is where much of the "politics" of the process occurs as elected members review priorities and make tradeoffs. Typically closing the gap between the two sets of tracks involves some combination of:

- changes to levels of service either temporarily (deferrals or slower delivery) or permanently (deletions or reductions in the scale of projects or resources given to meeting some needs)
- changes to funding sources
- efficiency gains (although opportunities such as shared service arrangements are generally options that could/should have been identified in the earlier stages of the process).

Decisions on the changes necessary to close the gaps are for elected members to make. It is an officer's responsibility to provide advice and generate options (for example a 2 percent cut in the rates across the board means that at least one of projects a, b and c cannot proceed, or alternatively this means libraries reduce opening hours, consent processing times increase and the like). The decision on which option to take must be the elected members. Nothing will undermine political ownership of the LTP more than elected member's perceptions that they are merely rubber-stamping officer's recommendations.

The five questions listed under the first step might prove useful aides when prioritising alternative expenditure proposals.

Some additional considerations to apply at this point of the process are:

- *legal requirements* – for example, is a piece of expenditure necessary to meet a legal requirement and what are the likely consequences if the expenditure does not occur, is the council certain that proposed changes to rating tools complies with the legislation (for example, could your local authority be at risk of breaching the 30 percent cap)
- *risk* – is some expenditure necessary to minimise or mitigate particular risks, and if so then is the risk something the council is prepared to live with (for example is the capacity of stormwater disposal infrastructure sufficient to cope with an increased frequency and severity of adverse weather events)
- *strategic consequences* – is a particular project central to the achievement of one or more of the council's strategic objectives (and if so then does deferral or deletion of the project mean that some amendment to these objectives may be necessary)
- *relationship with other projects* – is a particular project a pre-requisite for another project, or one that is complementary to another project (that is to say, something that is needed to ensure that the full benefits from another project are recognised)
- *financial and service level impacts, both short and long-term* – this information will also help you assess the prudence of your financial strategy (see below).

Step Five: Review Tracks and Repeat Process as Necessary

On conclusion of step four the results should be formally tested and another comparison of the desired and projected rates and debt tracks should be made. It may be that further options for closing the gap are needed (either because the gap has not closed, or the options that have been presented to date have undesirable consequences).

Testing the Strategy

Development of the strategy will most probably be an iterative process – with senior managers and elected members considering several drafts. They will (consciously or not) subject the strategy to tests for the affordability (and acceptability) of the outcomes. At the same time you need to

run a more formal, structured series of tests for financial prudence, and the overall coherence and transparency of the strategy.

3.3.5 Document the Financial Strategy

Having agreed upon a financial strategy it's now time to turn the strategy into something that can go into the LTP.

Your financial strategy provides the explanation of, and context for all of the financial content of your LTP, and a good many of the other policy and service delivery decisions taken during the LTP process. As such it's a key part of having the right debate with the community and should therefore be presented as one of the main issues for consultation. This is likely to mean the strategy:

- forms a key part of the LTP summary
- appears in a prominent place in the full LTP (most probably at or near the front of the main document).

Beyond the small number of statutory disclosures, there is no prescription as to the form that the strategy needs to take – its entirely over to you how to present the information.

An effective financial strategy should contain the following:

- key environmental factors and their financial consequences – for example if your community is growing what implications does that have for debt and revenue from rate and non-rate sources. Don't forget that the legislation makes a presumption that changes in population and land use are key factors (these must be covered regardless of their significance to your local authority).
- the trends in each of rate revenue, non-rate revenue (your local authority might break this down further if there are particular non-rate revenue streams that are significant – for example development contributions may be significant for a growing community), debt, operating expenditure and capital expenditure[9]. Discussion of the trends should begin with a brief overview of the current financial position
- discussion of the trends will be reinforced by your selection of the other significant factors to disclose. Look for those that:
  - *have a significant impact and scale* – for example, many metropolitan local authorities may find that capital expenditure on cultural and recreational facilities may approach or even exceed that on network infrastructure
  - *are associated with significant levels of public interest – typically these will be key projects or other expenditure items*
- the statutory disclosures (if not covered elsewhere in the document)
- key assumptions/uncertainties and an indication of what impact this might have. You might consider alternative scenarios – but always indicate the council's preferred scenario.

A few well explained graphs showing trends in some of the key financial trends will often be useful. However, avoid just putting a chart in without explanation or for the sake of putting a chart in.

[9] The statutory disclosures about the capital and operating expenditure requirements associated with catering for changes in population and land use, and the capital associated with maintaining levels of service for network infrastructure and flood protection/control works may be best presented as notes to these five lines.

Limits and Targets

The *limits* themselves can be presented in words or in a simple tabular form (the latter might work best in cases where the limits are to change at some point during the LTP process). Word the measures associated with your limits clearly and carefully – explaining any technical terms. Limits should be discussed and explained in the appropriate sections on rates and debt

Take care to express rate limits in aggregate terms with qualifiers – for example simply stating the rates increase will be no more than x percent in a particular year invites a ratepayer in a property that has had a large increase in property values to query compliance with your limits. Statements such as *"the council's total rate take will increase by no more than x percent – individual properties may experience larger or smaller increases depending on movements in property values"* may be more sensible. It is also desirable to leave yourself some room for contingencies – just in case of unexpected developments.

The statement discussing your local authority's ability to provide and maintain existing levels of service and meet additional demand is an opportunity to make the service level consequences of the limits known. If setting limits meant that a level of service was decreased, or that some planned increase was shelved then this is the place to note that – in this way you are creating the opportunity for the community to prioritise.

A tabular approach also works well with the *declaration of targets for investments and equity securities* – these should also be discussed in the section on non-rate revenue. Objectives for holding these securities can be briefly summarised in that same discussion.

Policies on Security

We have observed that the policies on giving of security on borrowing are generally quite short, in which case a note to the strategy may be sufficient. Those intending to subscribe to the Local Government Funding Agency should note that your policy may also need to cover the giving of security in relation to borrowing by this agency.

Transparency

How can you test the transparency of a financial strategy? The following may be of assistance

- *the summary test* - how easily can the basics of strategy be summarised for inclusion in the LTP summary. A strategy that cannot be described in a few pages may be too complex for the public to grasp (or alternatively may be an aggregation of the financials as opposed to a strategy).
- *the customer services test* – try giving the document to your customer services people (or your communications person if you have one). If they can produce an adequate explanation of the strategy it is likely to be pitched at about the right level. If they come back saying the strategy is that rates will increase by no more than x percent, then your discussion of your strategy may not have enough focus on the issues
- *expression of the limits* – have the limits been adequate explained – e.g. why is the limit on rates 5 percent per annum and not 3, what's the significance of an interest expense/ operating revenue ratio and why did you select this as the limit and not say the absolute dollar amount.

Structuring Your Financial Strategy

There is not a single right way to structure a strategy for disclosure in the LTP. One way that draws together the key elements is summarised below.

A. Summary

A short discussion that summarises the overall direction of your strategy, how it fits with the rest of the LTP and what it means for the public. This is the piece that your local paper is most likely to pick up once it has looked at the rates!

B. Key Financial Issues

(i) *The current financial situation and its relevance to the strategy* – for example, a council that is near its debt limits might explain why there is little/no room for borrowing and that new expenditure proposals may need to be financed from current revenue.

(ii) *Key factors in the operating environment and implications of these* – what things are expected to happen in your world and how do they influence your strategy. This would include the mandatory disclosures about changes in population and land use and the capital and operating costs of providing for those changes. Those significant forecasting assumptions with major financial implications might also be discussed here.

(iii) *Key level of service issues and the implications of these* – what are the really big ticket level of service issues and what are the financial consequences of those. For example, is the new stadium going to increase debt in the early years, and draw on current revenue for servicing, while needed repayment towards the end of the plan. The Act requires you to treat the costs of "steady state" levels of service as one disclosure that would fit here (e.g. funding everything to the current standards is expected to cost …..), and the costs from increased demand for services (both due to growth and a change in community preferences as another). Many of these will be explained in detail at the front of your LTP so discussion here should focus on the financial.

C. Financial Implications and Trends

Rates – key trends in rates income over the life of the strategy, explained with reference to the key financial issues from item A above. Your limits on rates and rates increases should be identified and explained at this point.

Non-rates income – trends in revenues other than rates, your local authority might disaggregate this depending on your particular circumstances (for example a high growth local authority might disclose development contributions as a separate item). Targets for investments might be disclosed here – but objectives are probably best left for an appendix (especially if you have a lot of different types of investment).

Debt – key trends in debt over the life of the strategy, explained with reference to the key financial issues from item A above. Your limits on debt should be identified and explained at this point. Your policy on security of borrowing should be disclosed here.

D. Implications

What are the service and other policy implications of the above. This would include your statement reconciling your limits on rates and debt and levels of service.

Things to Remember: Financial Strategy

1. A financial strategy is more than just a series of limits on rates and debt. It is both an overall direction for the financial 'side' of the LTP and a synthesis of the financial issues and consequences of your local authority's policy and service delivery decisions.

2. Your financial strategy is part of the content of an LTP – but is intended to factor in the way that your local authority manages the financials and makes policy and service delivery decisions with financial consequences. It is a key 'right debate' issue.

3. A robust financial strategy must be grounded in sustainability of service and therefore draws on (among other things) your asset information and activity management plans. A strategy that does not adequately reflect activity plans will struggle to demonstrate prudence and will probably be frequently breached.

4. While the Act sets out some mandatory content for a financial strategy – your strategy will reflect issues and concerns that are specific to your local authority. Financial strategies cannot be copied from other local authorities.

5. The impact of population change and land use change on operating and capital expenditure are mandatory disclosures – whether these are significant issues for your local authority or not. Likewise your strategy must disclose planned capital expenditure on network infrastructure and flood protection/control work.

6. Limits on rates and debt are a requirement, though these will be set by each local authority. There must be a limit on rates, rates increases and debt – though what your limits are, and how you express these is a matter for local choice.

7. Your limits, and the rest of the strategy are subject to the test of prudence. Part of that will include explaining how the limits impact on your ability to maintain levels of service and meet new demands for services.

8. Your financial strategy is a key part of having the right debate with your community. The strategy should therefore be included among the key issues for presentation in your summary LTP, and sit alongside the other key issues in the main LTP.

CASE STUDY: MANUKAU CITY COUNCIL'S 2009-19 STRATEGY

This strategy that follows is generally regarded as the best of the financial strategies from the 2009-19 plans. It is illustrative of the sorts of thought processes that go into preparing a financial strategy, and documenting the strategy for the public.

This financial strategy was prepared at a time when a financial strategy was not a mandatory part of an LTP. The document itself *does not meet the disclosure* requirements for financial strategies that were introduced in 2010.

As you work through the document look for:

- the setting and explanation of what was a de facto rates cap (rates will increase by about 1.4 percent above the expected rate of price change)
- the council's decision to smooth rates increases across the ten years
- the discussion of the council's approach to determining the affordability of rates and in particular the graphic demonstration that ratepayers will underpay in the early years of the plan and that this is recouped in later years of the plan
- the clear explanation of the financial impact of not increasing rates by a sufficient amount in the first year of the plan (debt increases)
- the explanation of drivers of expenditure.

Manukau placed this explanation of the financial strategy near the front of their 2009 plan. While this explanation was separate from the discussion of the key policy and level of service issues that the council had identified, it did follow immediately afterward.

Financial Overview

Introduction

The city is growing and is expected to continue to grow by 1.9 per cent per annum over the 10 years. This growth continues to place pressure on maintaining and creating an infrastructure to support a growing community at an affordable rate.

The council has spent a number of days considering the final long term plan. A key part of that consideration has been the affordability for the community of the work programme contained in the plan. Manukau is a growing city and the plan assumes that growth will continue. The economy is currently slowing and we have seen significant reductions in the level of development in both the residential and commercial sector, however this is not the first time growth within the community has slowed. While growth may vary from year to year we believe the assumed growth rate over the 10 years remains reasonable.

Overall the guiding principle in preparing this 10-year plan has been to ensure the council remains financially sustainable.

Balancing the budget

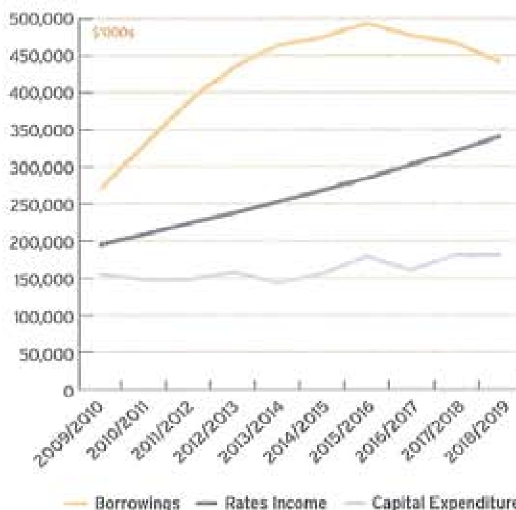
The council is required under the Local Government Act 2002 to ensure that each year's projected operating revenues are set at a level to meet each year's operating costs. This is a simple profit and loss test where council must make a surplus.

The council is further required to manage its revenues, expenses, assets, liabilities, investments and general dealings prudently and in a manner that promotes the current and future interests of our community. This requires a more holistic view of the costs and services council provides.

In assessing a financially prudent position, consideration is to be given to:

- the estimated expenses of achieving and maintaining the predicted levels of service contained in the 10-year plan, including the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life
- the projected revenue available to fund the estimated expenses associated with delivering services and maintaining the service capacity of assets throughout their useful life
- the equitable allocation of responsibility for funding the provision and maintenance of assets throughout their useful life
- the council's funding and finance policies.

The graph below shows the trend for rates, borrowings and asset development expenditure which are the key financial aspects of this plan. Inflation is assumed to average 2.4 per cent over the 10 years, which is included in all figures in the plan.



The council is forecasting that its operating expenditure will increase from $334 million to $460 million between 2009 and June 2019. These increases are as a result of:

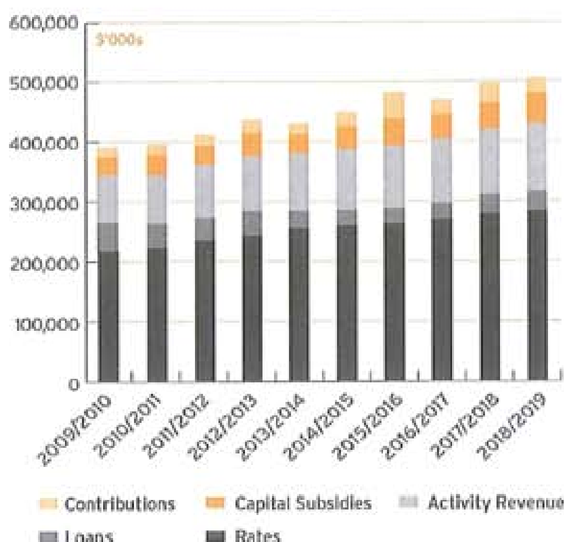
- Growth – there are or will be more households in the city based on our growth assumption of 1.9 per cent growth per annum
- Price increases – inflation and the factors that influence it will mean that it costs more to do business
- Service level increases – in some areas council will be providing a higher level of service
- Depreciation and interest payments – the increased capital expenditure programme means corresponding increases in costs in these areas.

Public consultation was undertaken on the draft 10 year plan in the knowledge that there was some capacity for council to increase expenditure in certain areas as a result of consultation, potentially reduce rates and have a higher level of debt while still adhering to the overall financial strategy adopted by the council. Council is comfortable that the changes made as a result of the consultation process do not disadvantage ratepayers.

The council has assessed the Local Government Act requirements and has adopted strategies to ensure that over the period of the 10-year plan, we continue to move to a financially sustainable position.

Financial Overview

The council pays for its services from a variety of sources with rates being the largest portion. The graph below shows how the council's activities are funded:



Rates and rates increase

The plan contains a rates increase at inflation for 2009/10 and at 1.4 per cent above the average rate of inflation for each of the next nine years of the plan. This means that rates will rise by around 2.8 per cent for 2009/10 and 3.8 per cent for each of the next nine years excluding the impact of the regional amenities levy. Given the current economic environment and the financial pressures our community is facing the council has reduced the rates increase in the 10 year plan to the underlying rate of inflation applied to council costs.

The council has general rates and targeted rates for refuse collection charge, business improvement districts and a new regional amenities rate for funding Auckland wide organisations. General rates are charged at different levels depending on the type of property and are levied on the annual value of the property.

The main impact from the targeted rates is the regional amenities rate which will add 1 per cent, 0.8 per cent and 0.7 per cent respectively to all ratepayers in the first three years of the 10-year plan.

The addition of the regional amenities levy means that the overall rate increase for 2009/10 will be 3.8 per cent.

The value of all properties within Manukau City Council boundaries are reviewed as part of the three – yearly valuations. These values were published in September 2008 and will come into effect from 1 July 2009 for rating purposes. The annual value for the average residential property has increased by 16 per cent over the past three years.

Depending on whether an individual property's annual value has changed by more or less than the 16 per cent average increase will impact on the actual rates increase for that property. If the value has increased by more than the average increase in values then the rates for that property will increase by more than the proposed rates increase. Conversely if the value has increased by less than the average then the increase in rates will be less than the average proposed rates increase.

Financial Overview

Given the current economic environment and the pressures faced by our community a large one-off rates rise is considered not viable. As such the funding shortfall is spread over the 10 years of the plan. This continues the strategy of the 2006-2016 10 year plan by having rates increases above inflation although this is now being spread over a longer period of time. However, to acknowledge the difficulties that ratepayers are facing, a 1% reduction in the rates increase for Year One of the plan has been agreed.

The impact of spreading this increase means that ratepayers in the first five years of the plan receive a benefit at the expense of ratepayers in the second five years of the plan.

Debt and interest

Council debt is predicted at the end of 10 years to be $440 million, with a peak in 2015-16 of $491 million. While this debt level is almost double our existing debt, it is still at an affordable level in relation to our income.

Due to changes made as a result of consultation the borrowings level is higher than the draft 10 year plan largely due to the following changes being made:

- Reduction of rates increase in Year One by 1%. This is to acknowledge that ratepayers are finding the current economic conditions difficult.
- Some asset development projects have been brought forward and are scheduled to be completed in earlier years of the plan
- The Prospective Statement of Cash flows better reflects the timing of cash receipts and payments anticipated over the 10 year plan.

As the table below illustrates even with the increased debt level, the council is operating well within the guidelines contained in the treasury policy.

	Treasury Policy	2008/09	2015/16	2018/19
Borrowings		$200m	$491m	$440m
Cash		($35m)	($19m)	($3m)
Net debt		$165m	$472m	$437m
Net debt as a % of income	<175%	59%	101%	79%
Net interest as a % of income	<15%	3.7%	7.1%	6.0%

The main reason for the increased debt is to fund the asset development expenditure programme proposed within this plan. If the council has too much debt then the future ratepayers will subsidise the current ratepayers.

The council has considered the timing of the programme and the associated borrowing required to ensure that this best meets the needs of current and future generations.

Asset development expenditure

The council currently has assets worth close to $5 billion and during the next 10 years the council is planning to undertake additional capital works of $1.6 billion. Asset development expenditure is for purchasing, building, replacing or developing the city's assets (e.g. roads, bridges, libraries). For each asset category, asset management plans are in place, which are the key planning tool for the maintenance, future renewal and additional assets required to meet increased levels of services or growth in the city. These are generally prepared for 20 years to allow council to have a view beyond the 10-year plan timeframe. The asset management plans also inform how the planned expenditure will be paid for.

The council has developed the asset development programme assuming that all projects will be completed in the year identified in the plan. However, past experience shows that due to external factors such as land acquisition or obtaining resource consents there can be delays in the completion of the project. Therefore projects that have similar amounts and funding may be substituted from the later years of the plan for other projects which have experienced delays. Conversely projects that are delayed in one year of the plan will be completed in the following years.

Renewals are the replacement programme for the existing assets. Levels of service improvements relate to where council believes the current assets do not provide an appropriate level of service. Growth assets are constructed to support the growing city and provide the infrastructure that is required by the increasing population.

Renewals of assets are generally funded from operating revenue and rates are set at a level to ensure that renewals can be funded from this source. However, given the level of rates increase that would be required to achieve this, the council has elected to borrow to pay for some of the renewals in the first five years of the plan. In subsequent years the growth in the rating base will mean renewals can be funded from operations. This is an important intergenerational issue as the current ratepayers are consuming part of the asset and not meeting the full cost of that consumption which then passes on to future ratepayers.

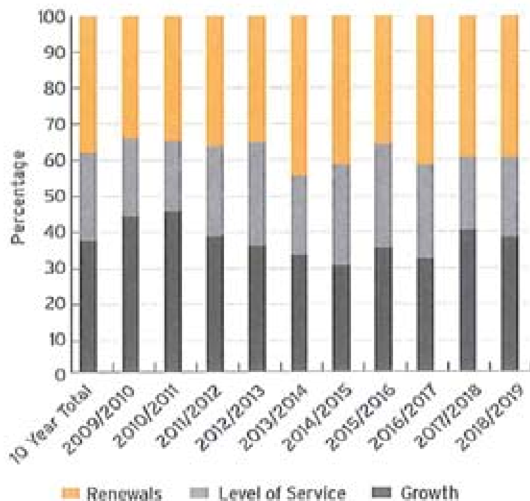
Level of service improvements and growth assets are generally funded from debt, capital subsidy or from capital contributions in the form of contributions (development contributions, financial contributions and cash in lieu of reserves). Contributions can fund capital works to the extent that the work contains an element of meeting the requirements of future growth. Each project within these categories has been considered to determine whether it is meeting future growth and if it does, then what portion of that work has a growth component.

Financial Overview

Contributions from development are generally paid after the council's asset development. The current balance of work undertaken to meet future growth is $30 million and while contributions of around $172 million are expected during the 10 years, the running balance in the development accounts is expected to be a deficit in excess of $60 million at the end of the plan. Based on the proposed level of capital works funded from development contributions the amounts levied are forecast to increase as follows:

Residential	$5956.00 + GST per HEU
Minor household units (less than 60m²)	$2978.00 + GST per minor dwelling*
Non-residential	$17.31 + GST per m²

The council has resolved to undertake an independent review of the methodology for calculating development contributions by December 2009. Until this review is completed development contributions will remain at the current levels

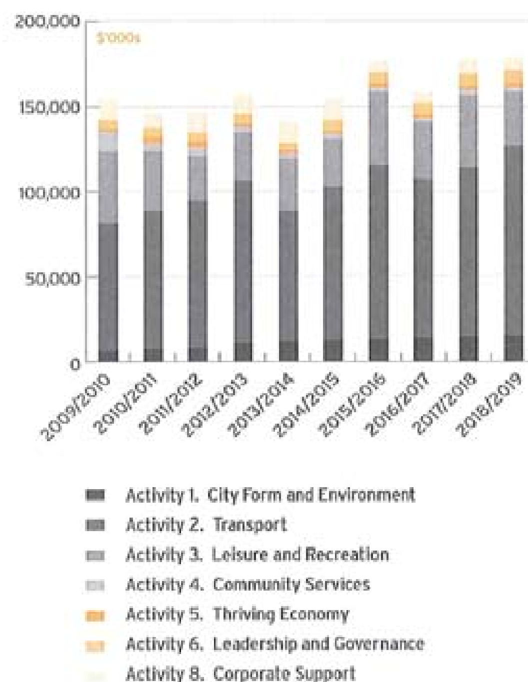


During the 10-year period our capital is relatively balanced between renewals, levels of service improvement and growth.

Transport is the largest asset area. However, over the next 10 years there are also additional community facilities (library and swimming pool) planned in the Flat Bush area and a rail station and car park in the Manukau Central Business District. Growth also puts pressure on the council transport network and the plan has a significant increase in transport related asset development expenditure compared to the 2006 plan. The main increases are:

- Increased provision for Auckland Manukau Eastern Transport Initiative (now $118m and additional funding for land purchases)
- Public transport and rail facilities in the Manukau city centre ($20m)
- Car parking in the city centre ($24m)

The split of capital expenditure by group of activities is as follows:



Most transport capital expenditure receives a New Zealand Transport Agency subsidy of between 43 per cent and 53 per cent. Those projects necessary to cover for growth will be partially funded by development contributions. Revenue from fees and charges will partially or fully cover operating and debt servicing costs associated with projects such as the Manukau City Centre car park, the Flat Bush aquatic, recreation and sports centre, and housing for the elderly units.

The council treads a fine balance when setting its 10-year programme. The programme needs to be established recognising that growth is occurring and that growth has a significant impact on the requirement for council services. While some assets are put in place by developers, the council must put in place most of the collective infrastructure and services. The council's service levels for community facilities reflect the geographic spread of the population and also reflect proximity to services for the population. Examples are for libraries and swimming pools which reflect that 98 per cent of the population will be within 3km and 5km (respectively) from the appropriate council facility.

Financial Overview

How much will my rates be?

Rates calculator

Write in your 2008 Annual Value here (available from your revaluation notice received from Quoteable Value or by going to www.manukau.govt.nz and accessing "Your Property")	(a)		
Uniform Annual General charge	(b)		$346.00
Rating factor from table below	(c)		
Multiply the annual value by the rating factor	(d) = (a) x (c)		
Regional Amenities Factor	(e)	$0.0026	
Multiply the annual value by the Regional Amenities factor	(f) = (a) x (e)		
Write in the number of dwellings here	(g)		
Annual Refuse/Recycling Charge (Residential & Rural only)	(h)	$185.00	
Multiply the number of dwellings by the refuse charge	(i) = (g) x (h)		
Add all the different rate types together (this is the total projected rates for your property)	(j) =(b) + (d) + (f) + (i)		

Rating Factors

Residential	$0.0354	Rural (Greater than 50ha)	$0.0132
Business	$0.0713	Refuse/Recycling Charge	$185.00
Rural (up to 50ha)	$0.0264	Uniform Annual General charge	$346.00

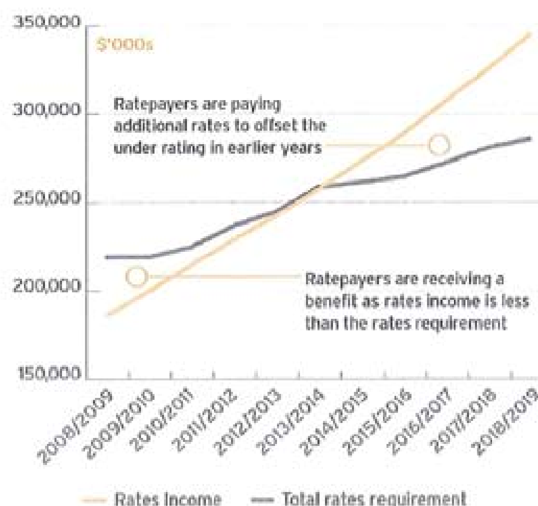
What is a reasonable rates level?

In setting rates at the appropriate level the council must balance what is affordable for both the council and community. This is a delicate balancing act which needs to take account of the services that the council delivers and whether the current or future ratepayers should pay for them. This is sometimes referred to as intergenerational equity. This is particularly important for the council given that many of its assets have long service lives and the benefits that these assets provide are over a long period of time. The main tool used is the use of debt and then rating future ratepayers to service the debt. This is similar to how many people purchase their first home.

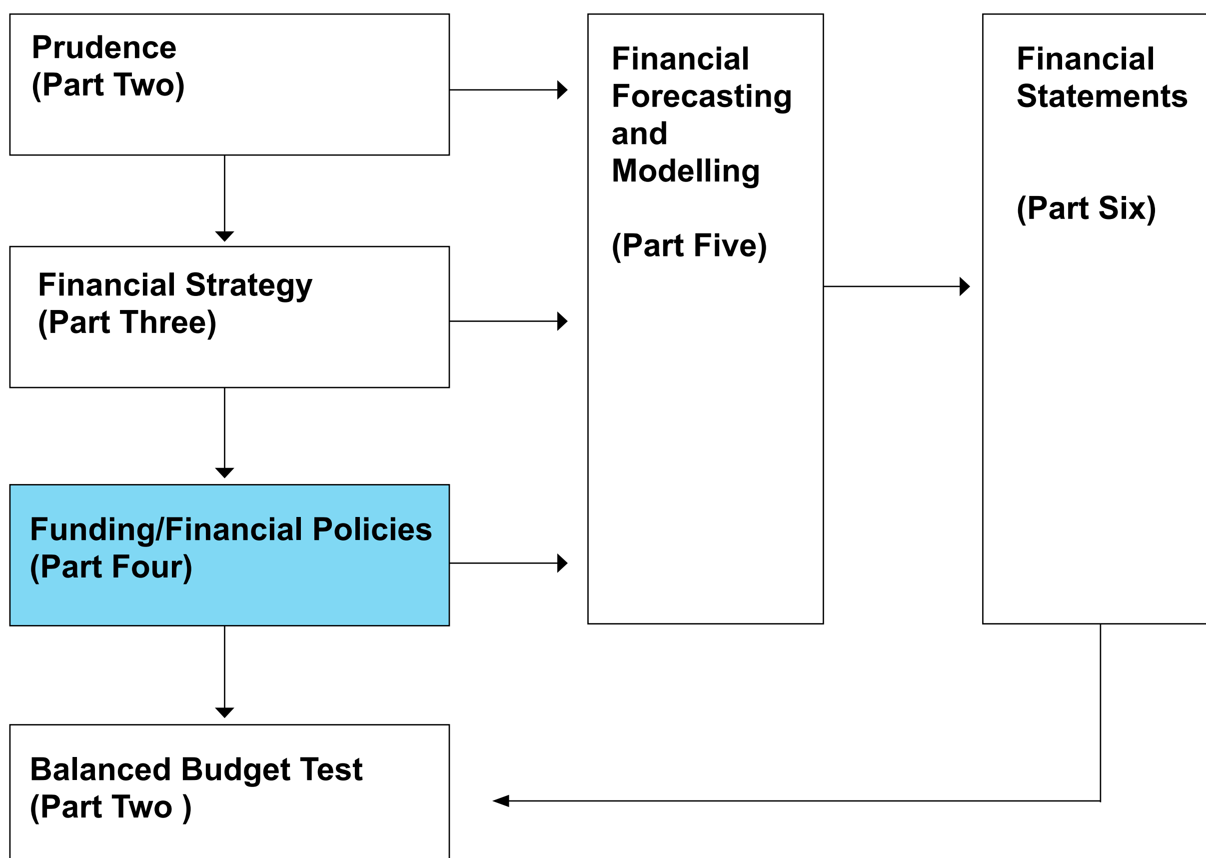
In assessing the appropriate funding level the council has to consider the following

- Have we set revenues at a level to cover all our expenses?
- Have we set our revenue at a level so that we can afford an ongoing asset renewal and replacement programme?
- Is the number of projects and the total cost of the asset development programme affordable?
- Have we considered the needs of current and future ratepayers?
- Overall have we balanced our budget?

Our analysis indicates that rates are not high enough in the first years of the plan to fund all the expenditure proposed within the plan. Historically rates have not been set at a level to fully fund our asset development renewals.



PART FOUR: FUNDING AND FINANCIAL POLICIES



Funding and financial policies (we will use the shorthand term '102 policies') are an important part of the long-term planning process. If:

- your local authority's performance management framework represents what your community can expect and
- the financial statements represent the cost then
- the funding and financial policies explain how the cost of achieving the plan will be apportioned.

This apportionment includes not only the 'who pays' but the 'when they pay' and 'how they pay'.

This section provides guidance on writing 102 policies that are meaningful, useful and compliant. Each of the following is discussed in turn:

- revenue and financing policy
- liability management policy
- investment policy
- policies for remission and postponement of rates on Māori freehold land
- policy on development contributions and financial contributions
- remissions policy, and
- postponements policy.

Amendments to the *Local Government Act* during 2010 mean that most of the 102 policies do not have to be included in LTPs from 2012. The revenue and financing policy (RFP) will be the only mandatory inclusion in the LTP.

4.1 Funding Principles and Process

4.1.1 Why are the Funding Principles and Process Important?

When making funding policy your local authority will need to work through the process and matters set out in *section 101(3)* of the Act. These requirements provide local authorities with a list of matters to consider as part of the development of a transparent revenue system. The *section 101(3)* requirements recognise that funding policy is more than just a device for raising revenue, but is also one of the instruments that your local authority may wish to use to promote community wellbeing.

Section 101(3) analysis also features in:

- *the revenue and financing policy* – this document sets out your local authority's selection of funding sources for capital and operating expenditure and the rationale for that selection of tools. It is also the means for explaining how you applied *section 101(3)*
- *the policy on development contributions or financial contributions* – must explain how capital expenditure will be funded and explain the rationale for those choices in terms of *section 101(3)*.

Section 101(3) analysis is therefore critical to the success of your local authority as it provides the basis for your funding.

4.1.2 Step One Analysis

Section 101(3) analysis is basically a two-step process. The first step requires consideration, at activity level (this is one of the few LGA disclosures required at this level) of each of the following:

- *community outcomes* - the community outcomes to which the activity primarily contributes (in other words your rationale for service delivery)
- *the user/beneficiary pays principle* – the distribution of benefits between the community as a whole, any identifiable part of the community, and individuals
- *the intergenerational equity principle* – the period in or over which those benefits are expected to accrue
- *the exacerbator pays principle* – the extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity, and
- the costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities.

These five matters all carry equal weight *in law*. This does not mean that your local authority may not adopt a policy which assigns more weight to one than the others – but your policy must be able to demonstrate consideration of each of the above, for each activity.

Don't forget that the RFP must disclose funding sources for operating and capital expenditures, while 101(3) does not distinguish between the two, it is useful to look for standout cases now.

The community outcomes to which the activity primarily contributes

This is a statutory signal that your local authority should be considering its rationale for service delivery (although the Act only requires consideration of community outcomes, good practice suggests consideration of the other priorities of your local authority). This gives further emphasis to the need to pay attention to the rationale for service delivery.

Example: Swimming Pools
Many local authorities state that their rationale for providing swimming pools revolves around either promoting community health or widening the set of leisure opportunities available to the community. If this is the objective then a selection of funding instruments that applies a '100 percent user pays' policy may restrict access for lower income groups, which may not be consistent with the rationale for service delivery.

The distribution of benefits between the community, identifiable parts and individuals

This is also sometimes referred to as the 'user/beneficiary pays' principle. Activities that predominantly benefit the community in general (economists call these public goods) are generally better candidates for funding mechanisms that are levied on the community as a whole (such as a general rate). Activities that benefit particular individuals or groups tend to be better candidates for mechanisms that sheet the costs home to those individuals or groups (such as targeted rates and fees and charges). Many of the services provided by local authorities tend to fall somewhere between these two 'poles' in which case – depending on your other analysis your local authority might apply a mix of tools, or might make a judgement to use a single funding mechanism.

Your rationale for service delivery may well highlight a number of different aspects of a particular activity that have different mixes of public and private good. There is no single right answer to these questions (case law also recognises this – see the Court of Appeal decision in *Woolworths vs Wellington City Council* for more details).

Example: Libraries
Generally speaking, library functions can be grouped into three main categories – lending services, reference services and preservation of heritage. Lending services might well be viewed as having a large amount of private benefit in that the good is both rival in consumption (if I'm reading a book you can't) and excludable (that's what a library membership does). However, if your rationale for service delivery is focussed around educational benefit your local authority might well consider promotion of reading to be desirable in which case lending services might then be viewed having some part of public benefit.

Period over which benefits occur

This is sometimes called the intergenerational equity principle. Many of the activities provided by local government have very long lives – and the benefits from these services will be enjoyed not just be today's ratepayers, but those for many years to come. This matter requires consideration of how benefits are distributed over time and the merits of applying funding sources that achieve a spreading of the cost over time.

The main tool for ensuring intergenerational equity is the use of term debt, and then rating future ratepayers to service the debt. This is similar to the way many people purchase their first home. A decision not to borrow for new capital is effectively a decision that current ratepayers should meet the cost of services future ratepayers will consume, and should be made as a conscious policy choice.

The extent to which actions or inactions contribute to a need to undertake the activity

This is sometimes referred to as the exacerbator pays principle and basically holds that those whose actions gives rise to a need to undertake a particular activity should meet part of the cost of that particular activity.

Example: Flood and River Control
The exacerbator pays principle has been used by regional councils for many years as part of the basis for flood and river control rates. Application of beneficiary pays principles suggests that the ratepayers who live on hillsides should pay these sorts of rates only to cover the fact that property access and other public facilities are protected.

However the rainfall on hillside properties tends not to be absorbed by the ground to the same degree and thus tends to result in water 'running off' to the land below and adding to the volume of water in the catchment.

Regional councils have used the exacerbator pays principle to justify extending flood control rates to the hill country properties – decisions which have been upheld in legal action (see the Court of Appeal decision in *Brocklesby and Others vs Waikato Regional Council)*.

Costs and benefits from funding the activities distinctly from other activities

Your local authority must consider whether there is any advantage to funding the activity separately from others – in other words is this an activity that could be funded from a general funding source (such as rates) or a targeted source (such as a targeted rate, fee or charge etc). Some useful things to consider are:

- *the financial scale of the activity* – the smaller the activity is the less likely it is that separate funding will be economic
- *the administrative costs involved in funding the activity separately* – for example the cost of creating the information necessary to administer a targeted rate on the rating information database and adding extra information to the invoice, invoicing and collection of a fee or charge etc
- *legal requirements* – occasionally the law may require you to 'ring-fence' an activity. For example, if your local authority is considering offering a lump sum option for some activity then it must apply a targeted rate for the capital component
- *promotion of value* – separating some activities, especially those funded from rates, may assist your local authority in its promotion of value for money. This is particularly relevant for some of the utility based activities such as water, refuse collection, and sewage disposal. There may also be other activities where your local authority may see a benefit in the community clearly being able to see what it is 'getting for its money'.

Example : Urban Water Supply
Approximately 20 local authorities operate water metering for one or more of the 'town' water supplies using the powers available under *section 19* of the *Local Government Act*. How might they have arrived at this decision:

- *other benefits* – there is a large volume of research that demonstrates that volumetric charging for water is a good tool for demand management and water conservation which can defer the need for capital work, decelerate the wear and tear on the network and so on
- *legal requirements* – metering water can only be done using a targeted rate (*section 19*) or as a user charge (*section 12, Local Government Act*)
- *administrative costs* – there are costs involved in reading and maintaining meters and depending on how the rate is administered either additions to the rates assessment and rates invoice or even a separate invoice
- *promotion of value* – by displaying not only the amount that is payable but the level of consumption, there is a clear linkage between charge and use, and of what the charge is 'paying for'.

4.1.3 Step Two Analysis

Once you have given consideration to how the matters in *section 101(3)(a)* apply to each activity you can move to the second step of the process. By now you will have some indication of the funding sources that you might use to fund each activity, and thus an indication of what the overall call on each source is likely to be.

Your local authority must then consider the impact of this allocation on the current and future wellbeing of the community. This consideration may lead to some alteration to your results from 101(3)(a). This process of consideration and modification cannot be done as part of the first step of the process, for that reason its important not to treat the second step of the process as an 'add-on'.

The following are examples of things that your local authority might consider in its *section 101(3)*(b) analysis. This is presented as a starting point to stimulate thinking and is not intended as an exhaustive list (nor is it a list of the things that must be considered):

- legal and other constraints (*section 21* cap on fixed rates and the like)
- what is the likely impact of the mix of funding sources on the elderly and others on fixed incomes or low incomes (in other words is there a genuine affordability issue)?
- will the policy act as a barrier to the accessibility of some services (such as cultural and recreational facilities)?
- what implications does the policy have for community groups?
- is the policy likely to have any effect on people's participation in community activities?
- what is the size of changes in funding arrangements – is some sort of transitional process necessary?
- is the mix of funding sources financially sustainable?
- what effect is the mix of funding sources likely to have on any particular sectors of your community?
- what are the current economic conditions and projected conditions over the life of the policy?
- what incentives will the policy have for development in the district?
- what incentives does the policy provide to conserve scarce resources?

- does the policy provide incentives for people to avoid environmentally 'unfriendly' activities?
- what incentives does the policy provide for the preservation of natural heritage?
- what impact might the policy have on people's participation in sporting and cultural activities?
- does the policy incentivise preservation of historic and cultural heritage?
- are there particular community or cultural groups that will be advantaged or disadvantaged by the policy?

4.1.4 Documenting Your Funding Policy Process

While not all of your analysis has to be disclosed, it is important that you document the entire process of analysis. Documenting the process provides protection in case of challenge, so that you can demonstrate both that the process has been undertaken and that your local authority has considered everything it should have. Documenting the process also provides a helpful 'safety check' that everything has been considered and seeing things 'in black and white' can also be a useful

For each activity your documentation should clearly record:
- how each of the considerations in 101(3)(a) applied and how your local authority reached that decision (including supporting evidence if relevant), and
- the results of your consideration in terms of an indication of the funding sources that emerged from the step one analysis

Figure 4.1 shows one approach to documenting the results of the first step of the funding policy process.

Figure 4.1: Documenting Section 101(3) Step One Analysis

Activity	Community Outcomes	Who benefits	Period of benefit	Whose acts create a need	Separate Funding	Funding Sources	Rationale
Aquatic Services (You might state the level of cost of the activity – separated into the operating and capital elements).	Active City – this activity provides the community with an opportunity to participate in active leisure.	The users benefit from personal fitness and competition. However this also a community benefit in providing options for people to exercise and relive pressure on the health system. The aquatic facilities can also be used to attract regional and national sports events.	The central pool facilities have a service live of 50 years. The proposed western suburb pool is expected to have a similar life. Council has borrowed for the central pool and is currently repaying the loan. The council also proposes to borrow for the western pool	Growth in the western suburbs has exacerbated demand for a second facility.	Funding the growth component by development contribution will require separate attribution of cost drivers and a separate mechanism. Large degree of private benefit, and ability to exclude people from the aquatic centre make user charging feasible.	**Operating** General rate 30-40 percent. Fees and charges 60-70 percent **Capital** Borrowing 75-85 percent General rate 10-20 percent Developer contributions 1-10 percent	**Operating** Although there is a large degree of private benefit, the council's rationale for service delivery (promoting active leisure) means full recovery from fees and charges is inappropriate. **Capital** This asset has a long life –borrowing enables council to spread costs evenly between current and future users. While growth in the western suburbs has added to demand it is not the only driver for the second facility. Small level of development contrib is appropriate.

For the *total set of activities* documentation should include:
- a description of the matters taken into account when assessing the impact on well-being and how they applied, in other words what modifications you made to the step one results and why, and
- the final selection of revenue and financing mechanisms both across the local authority, and for each group of activity.

You would then append a narrative describing:
- any impacts on wellbeing that your local authority took into account
- why those matters were important
- how those matters influenced your local authority's selection of funding sources.

4.2 *Section 102* Policies – the Legal Requirements

Amendments made to the Act during 2010 made a number of small-scale changes to the content, processes for adoption, and vehicles for disclosing 102 policies.

The policy on partnerships with the private sector has been removed altogether. Your local authority need not have such a policy at all. However this policy may be a useful device for ensuring that local authorities consider and manage the risks involved in these kinds of arrangement. If your local authority is likely to make frequent use of these arrangements a policy could be considered for inclusion in your stock of organisational policies.

The RFP is now the only 102 policy that must be included in the LTP. Your financial strategy is governed by different provisions and is therefore not regarded as a *section 102* policy. Only significant amendments to an RFP now qualify as an LTP amendment – other amendments need not be audited but are still subject to consultation via the special consultative procedure.

The remaining policies can be removed from LTPs as of the 2012 LTP. The intent of this was twofold – first it removes some of the operational detail from the LTP, second removal from the LTP means that a change to any policy falls outside of the scope of an LTP amendment. Significant changes have been made to the policies on liability management and investment. The more strategic elements of these documents have been moved to the financial strategy including:
- limits on borrowing
- policies on security for borrowing
- targets for investments.

As the investment and borrowing management policies are now entirely operational in nature, once you have a financial strategy in place, both these policies could be adopted by council resolution and can be amended as council sees fit. There are no mandatory consultation requirements with either of these policies.

The content requirements of the other policies (remission, postponement, Māori freehold land and development contributions) remain as in the 2002 version of the Act. These policies must be reviewed via special consultative procedure at least:
- once every three years in the case of a policy on development contributions
- once every six years in the case of the policies on remission, postponement, and remission and postponement of rates on Māori freehold land. The former two policies are mandatory only if your local authority wants to remit and postpone rates on general land.

Most 102 policies now need not be included in the LTP. You might consider placing summaries of your current policies in the LTP – especially where those policies are closely linked to significant sources of revenue (so for example in a growing local authority it may be desirable to put your policy on development contributions in the LTP).

It's also worth noting that *section 83A* enables you to combine consultation in an LTP or Annual Plan with consultation on other policies. For example, you might consult on your development contributions policy alongside the LTP, and on the rates remission and postponement policies in the annual plan.

4.3 Revenue and Financing Policy

4.3.1 The Legal Requirements

The RFP sets out your policies on why and how funding sources are used to fund operational needs and capital needs, for example why did your local authority choose capital value rating etc.

The actual legislative requirements are two-fold. Your RFP must:

1. state any policies your local authority has on the funding of operating and capital expenditure from the following sources:
    - general rates (including the choice of valuation basis, differential rates and the use or otherwise of uniform annual general charges)
    - targeted rates (but noting that the act does not specify any further disclosures – in other words the revenue and financing policy need not disclose the basis on which the rates are set, and the basis for any differentiation)
    - fees and charges
    - interest and dividends from investments
    - borrowing
    - proceeds from asset sales
    - development contributions
    - financial contributions
    - grants and subsidies
    - any other source

2. the policy must also show how the selection of funding sources in your policy complies with the funding policy process in *section 101(3)*.

However your policy must also be transparent and not merely comply with the legislation. This is the policy that the interested ratepayer will go to as it is intended to show who is going to pay for what, when, as well as showing how the council came to that decision. Your RFP should aid in understanding your financial statements, both at (groups of) activity level and at local authority level.

What are the practical implications of this?

The RFP is the place to disclose any policies your local authority may have regarding selection of particular funding instruments. For example, this includes going to the legal maximum on uniform annual general charges, or borrowing for some capital works but not for others. It is also the best place to explain the construction of any differential rating policies and your local authority's rationale for these.

The disclosure requirements apply to both operating and capital expenditure. The legislation does not specify that there should be separate disclosures for each. However, the funding sources for capital expenditure are sometimes quite different from those that apply to operating expenditure. Mixing the two will have the effect of distorting the overall picture, especially if your local authority has a sizeable capital works programme perhaps associated with a large borrowing requirement. Disclosure of capital expenditure sources becomes especially important if your local authority intends to use either development contributions or financial contributions.

Your demonstration of how your local authority applied *section 101(3)* is likely to change between LTP processes as your local authority starts or ceases activities, the policy rationale for undertaking activities changes, elected members change priorities, or some external change forces a reconsideration of the second step of the process. The implication of this is that your RFP is not something that can be merely rolled over from one LTP to the next – while the preparation of a policy need not be done from a 'zero base' there will be changes from plan to plan.

Your RFP has logical linkages to each of the following that should not be neglected:

- *forecast financial statements* - the RFP should aid in the readers understanding of the financial information in the cost of activity statements (especially) and the forecast financial statements
- *funding impact statement (FIS)* – the FIS is the mechanism for implementing the revenue and financing policy. In effect, the FIS is the linkage between the revenue and financing policy and the actual setting of rates and charges. This is the document that provides the majority of the detail as to how rates will be set and not the revenue and financing policy.

4.3.2 Good Practice for Revenue and Financing Policies

Principles for a Revenue and Financing Policy

The following are useful principles to keep in mind when developing an RFP:

- *transparency* – the overriding purpose of an RFP is to show who pays for what and why. The content of your policy should be tailored in such a way as to meet the legislative requirements and this test – a policy that does not do this cannot provide the predictability and certainty described in *section 102*
- *easy to understand* – avoid the use of terminology if you can, if you need to use technical terms define these in everyday language. Thresholds and percentages may also be useful to make the policy concrete
- *robust* – the policy should be based on a clean set of funding/financial principles and sound underpinning analysis and documentation. Policies that can demonstrate this are more likely to withstand legal and ratepayer scrutiny
- *fair and equitable* – linked to realism, the policy is your local authority's opportunity to explain what it considers 'fair and equitable' to represent. Without this fairness and equity remain a concept that is ' in the eye of the individual ratepayer'
- *durable* – the policy should retain relevance in spite of day to day changes in the environment
- *realism* - like the remainder of the LTP, the RFP represents a commitment to the community by your local authority and in particular elected members. A document that is 'aspirational' but sets results that are not 'feasible' is unlikely to survive an LTP cycle. The obvious implication of this is that elected members must be involved in the development of the RFP.

Specification of the Policy

The intent of the RFP is to show what, and why, the rest is an implementation detail. The RFP need not provide a detailed description of every fee and charge. Describing exactly how each rate or charge is set adds considerably to the length of the RFP and may have the effect of reducing rather than enhancing transparency.

In some cases some level of detail is prescribed. Your RFP must identify your choice of valuation basis, whether you use differentials and the use of uniform annual general charges. Your disclosure of this in an RFP would then be something like:

'General rate – ABC district council levies the following general rates:

- *a uniform annual general charge* (if this local authority had a policy of going to the maximum it would then follow this with some form of disclosure along the lines of 'this charge is set at a level such that x percent of the rate revenue will be generated by this charge' and explanation of why the policy is in place)
- *a rate per dollar of rateable capital value, differentiated on the use to which the property is put and the location of the property*. This would then be followed by a rationale for the use of both the valuation system and differentials. Simple statements along the lines that *'the council considers the capital value system produces the fairest allocation of rating liability'* go some way towards providing a rationale but need further explanation as to why that judgement was made.

Your disclosure for targeted rates need only specify that a targeted rate will be used to fund a particular activity or activities and briefly explain why. You are not required to disclose the basis on which the rate will be calculated in your RFP (but you will need to disclose this in the FIS).

Capital Expenditure

A 'pooled' approach to funding capital expenditure (i.e. one disclosure for your entire capital programme). may be an acceptable approach if your rationale for selecting particular funding sources over others is clear. This might, for example, take the form of a hierarchy of sources or clear descriptions of when funding sources would be used.

However, changes made during 2010 have placed greater emphasis on disclosing and explaining capital expenditure and the drivers of capital expenditure. Your community may then expect greater explanation of funding sources for renewals, changes in levels of service, and the costs attributable to growth. Don't forget your selection of funding sources is often quite different for each. For example, renewals tend to be funded from rates and reserves whereas new assets are often funded from borrowing (and those to service growth may also be funded via development contributions). This sort of disclosure provides further support for your policy on development contributions or financial contributions (and which will be something developers will be looking for).

Determining RFP Amendments

The TAFM legislation changed the requirements for amendments to an RFP – all amendments to an RFP must be made through special consultative procedure, but only the significant amendments need be audited.

The use of the term 'significant' is a clear signal from Parliament that it intended that your local authority should follow much the same process for determining the significance of RFP changes as it would with other decisions. That is, that your local authority would consider:

- the current and future social, economic, environmental and cultural wellbeing of your community and how the proposed RFP amendment might impact on this
- any persons who are likely to be particularly affected by, or interested in the proposed RFP change
- the capacity of your local authority to perform its role and the financial and other costs of doing so and (of course)
- the content of your own significance policies (it may be useful to give these a review in the light of the TAFM legislation).

What does this all mean? Simply put:

- the second aspect of this definition is most likely to have relevance to determining whether most changes to an RFP are an LTP amendment
- changes to an RFP that result in anything other than minor changes in the incidence of the overall mix of funding will probably remain an LTP amendment (such as a change in the valuation base for the general rate, or the introduction of or major change to a uniform annual general charge)
- the introduction of a new targeted rate or charge may be an LTP amendment – depending on the amount of the rate/charge, the size of the group on which it is levied, and its impact on wellbeing. The larger the absolute amount of the rate and the impact of the rate/charge on wellbeing the more likely it is that an amendment will be triggered
- introduction of a new rate or a substantial increase in a rate/charge that targets a small group <u>may</u> trigger significance[10]. In these circumstance, regardless of whether you actually consult, its wise to ensure that:
  - your local authority has good up-to-date information on the views of the people interested in/affected by the change
  - your local authority makes records to show that information has been considered
  - the decision whether or not to consult and the reasons for that decision, have been carefully documented.

Percentages and Thresholds

The RFP is a particularly important part of the LTP – the more understandable it is, the better.

Stating that your local authority intends to fund a given activity through a mix of the general rate, a targeted rate and fees and charges will struggle to comply with the legislation. Such an approach is also of minimal usefulness to readers, who will be unable to understand your intentions, gauge the likely impact of the policy upon them, or even determine whether you have complied with your policy.

One useful presentation tool to help the reader understand the linkages between the revenue and financing policy, the cost of activity statements and the financial statements is the use of percentages and thresholds in your disclosure. This does not mean that your RFP needs to be specified with military precision. Indeed too great a level of precision is probably spurious given the imprecise nature of some funding tools. Rather than a set percentage your local authority may find that specifying a range of percentages or thresholds may provide more transparency without too much detail.

One of the things to watch out for if you move to including percentages in the RFP is that these do not become an end in themselves (these can be popular with the community as they are readily

[10] A good example of circumstances where a significant increase in a charge paid by a relatively small group was seen as a significant decision can be found in the decision of Chisholm J *in Council of Social Services vs Christchurch City Council (2008)*.

understandable). The percentages and thresholds you include in the RFP should be linked in some way to service delivery objectives (including the rationale for service delivery).

In the example in the Appendix to this part note the use of de-facto ranges in the policy – though some may be a little broad for the purist (for example is residual referring to something that is 49 percent of expenditure or 10 percent)

This is where your *section 101(3)* analysis can be especially helpful. For example in the case of a library where there may be wider education objectives, your discussion of community outcomes will have highlighted this. It would then logically follow that your local authority might set user fees at or close to marginal cost i.e. a low-moderate percentage of revenue for recovery.

Showing Compliance with Section 101(3)

In previous LTPs many RFP documents were very lengthy. Many included the full set of workings in their policies (for example by using a format similar to that in Figure 4.1). Such an approach demonstrates a more certain level of compliance with the legislation. However, the additional content in the LTP does not make it easy for the user to locate information regarding a particular activity (although careful structuring/signposting can resolve this).

Figure 4.2 shows a 'real life' short-form RFP that has been cited as a good approach in recent OAG publications. Essentially Manukau City did the *section 101(3)* analysis and then devised a number of different labels to use as descriptors for funding at the level of an individual activity. These labels and a basic classification of activities and revenue sources than form the basis for the table covering operating expenditure that appears on the first and second pages. For example:

- *full* means that the activity was fully funded from the indicated funding source e.g. community development was fully funded from the general rate
- *subsidy* meant a portion was funded by central government subsidy and so on.

Each descriptor is explained on page two of the policy together with discussion of the circumstances where the particular descriptor is relevant. That explanation is central to both the compliance and transperancy of the policy.

For capital expenditure the council concerned has taken something of a pooled approach and described each source and the circumstances in which it will be used.

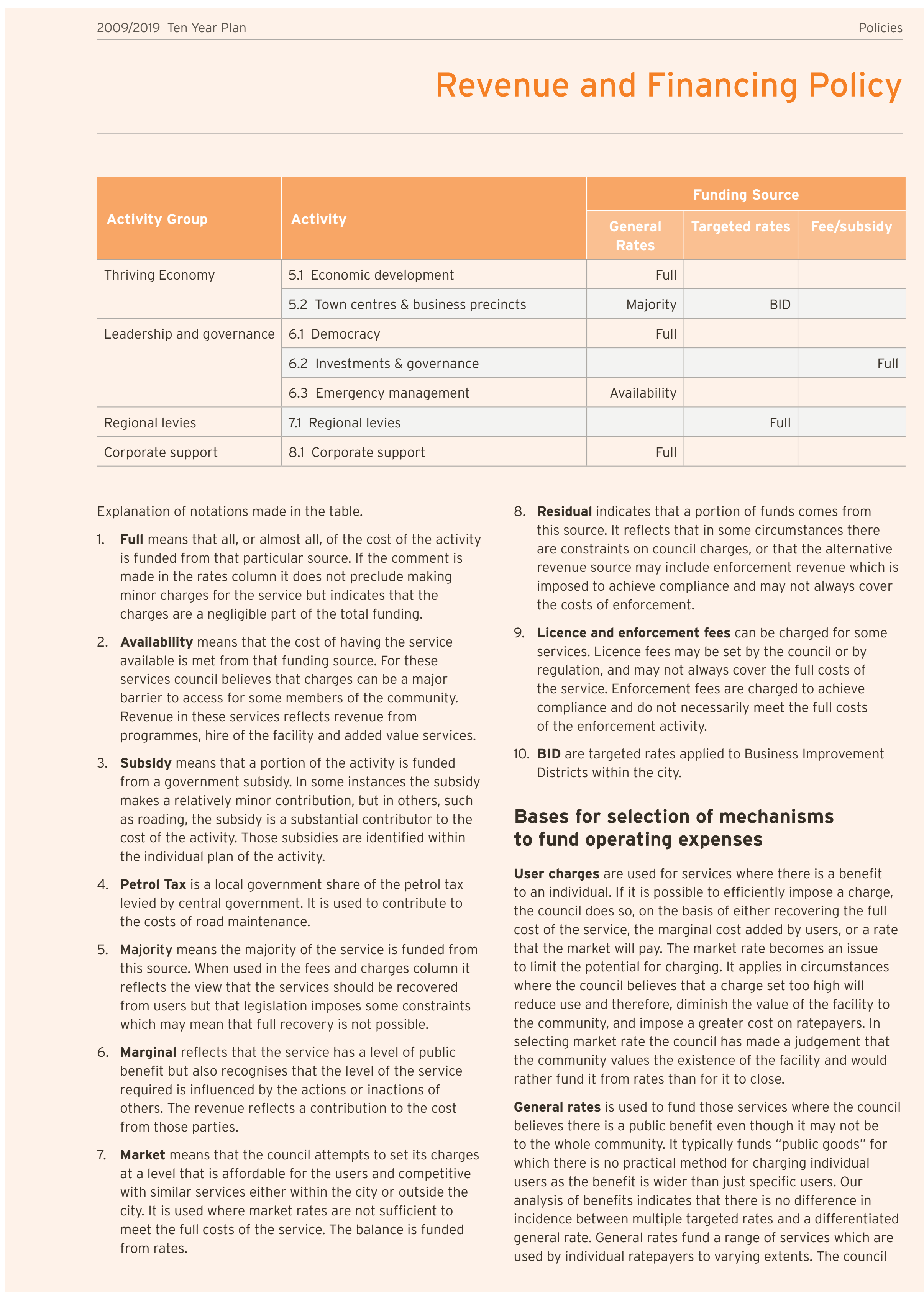
The result is a policy that is short, generally very clear (all terms are defined well and examples shown that help the reader understand when each might apply). The descriptive terms act as a range of target percentages – albeit quite wide ones, that give the policy a fair amount of durability. There is a clear separation of operating and capital expenditure and the different sources for each are clearly explained. The principles of *section 101(3)* are included in the policy and woven throughout the explanations.

Readers should note that the RFP in Figure 4.2 was backed up with extensive supporting documentation that explains how the council got to this conclusion. The council concerned also supports the RFP with a rating policy. The disclosures on capital expenditure are relatively simple because, among other things – the council operates a corporate level approach to borrowing and a city wide policy to development and financial contributions. In other words, this approach is a tool for presenting *section 101(3)* analysis and not a shortcut for it.

The other thing to watch for with this policy is that the reason it is supported with a rating policy (and this is included in the LTP) is that some of the disclosures around the general rate are not in the RFP itself. The valuation basis is missing, the only statement on differentials is that the council

does use them etc. We suggest minimising risks by adding statements to your own policy that deal with general rates.

Figure 4.2: A 'Short-Form' Revenue and Financing Policy – Manukau City



Revenue and Financing Policy

Activity Group	Activity	Funding Source		
		General Rates	Targeted rates	Fee/subsidy
Thriving Economy	5.1 Economic development	Full		
	5.2 Town centres & business precincts	Majority	BID	
Leadership and governance	6.1 Democracy	Full		
	6.2 Investments & governance			Full
	6.3 Emergency management	Availability		
Regional levies	7.1 Regional levies		Full	
Corporate support	8.1 Corporate support	Full		

Explanation of notations made in the table.

1. **Full** means that all, or almost all, of the cost of the activity is funded from that particular source. If the comment is made in the rates column it does not preclude making minor charges for the service but indicates that the charges are a negligible part of the total funding.
2. **Availability** means that the cost of having the service available is met from that funding source. For these services council believes that charges can be a major barrier to access for some members of the community. Revenue in these services reflects revenue from programmes, hire of the facility and added value services.
3. **Subsidy** means that a portion of the activity is funded from a government subsidy. In some instances the subsidy makes a relatively minor contribution, but in others, such as roading, the subsidy is a substantial contributor to the cost of the activity. Those subsidies are identified within the individual plan of the activity.
4. **Petrol Tax** is a local government share of the petrol tax levied by central government. It is used to contribute to the costs of road maintenance.
5. **Majority** means the majority of the service is funded from this source. When used in the fees and charges column it reflects the view that the services should be recovered from users but that legislation imposes some constraints which may mean that full recovery is not possible.
6. **Marginal** reflects that the service has a level of public benefit but also recognises that the level of the service required is influenced by the actions or inactions of others. The revenue reflects a contribution to the cost from those parties.
7. **Market** means that the council attempts to set its charges at a level that is affordable for the users and competitive with similar services either within the city or outside the city. It is used where market rates are not sufficient to meet the full costs of the service. The balance is funded from rates.
8. **Residual** indicates that a portion of funds comes from this source. It reflects that in some circumstances there are constraints on council charges, or that the alternative revenue source may include enforcement revenue which is imposed to achieve compliance and may not always cover the costs of enforcement.
9. **Licence and enforcement fees** can be charged for some services. Licence fees may be set by the council or by regulation, and may not always cover the full costs of the service. Enforcement fees are charged to achieve compliance and do not necessarily meet the full costs of the enforcement activity.
10. **BID** are targeted rates applied to Business Improvement Districts within the city.

Bases for selection of mechanisms to fund operating expenses

User charges are used for services where there is a benefit to an individual. If it is possible to efficiently impose a charge, the council does so, on the basis of either recovering the full cost of the service, the marginal cost added by users, or a rate that the market will pay. The market rate becomes an issue to limit the potential for charging. It applies in circumstances where the council believes that a charge set too high will reduce use and therefore, diminish the value of the facility to the community, and impose a greater cost on ratepayers. In selecting market rate the council has made a judgement that the community values the existence of the facility and would rather fund it from rates than for it to close.

General rates is used to fund those services where the council believes there is a public benefit even though it may not be to the whole community. It typically funds "public goods" for which there is no practical method for charging individual users as the benefit is wider than just specific users. Our analysis of benefits indicates that there is no difference in incidence between multiple targeted rates and a differentiated general rate. General rates fund a range of services which are used by individual ratepayers to varying extents. The council

Revenue and Financing Policy

Activity Group	Activity	Funding Source		
		General Rates	Targeted rates	Fee/subsidy
Thriving Economy	5.1 Economic development	Full		
	5.2 Town centres & business precincts	Majority	BID	
Leadership and governance	6.1 Democracy	Full		
	6.2 Investments & governance			Full
	6.3 Emergency management	Availability		
Regional levies	7.1 Regional levies		Full	
Corporate support	8.1 Corporate support	Full		

Explanation of notations made in the table.

1. **Full** means that all, or almost all, of the cost of the activity is funded from that particular source. If the comment is made in the rates column it does not preclude making minor charges for the service but indicates that the charges are a negligible part of the total funding.
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6. **Marginal** reflects that the service has a level of public benefit but also recognises that the level of the service required is influenced by the actions or inactions of others. The revenue reflects a contribution to the cost from those parties.
7. **Market** means that the council attempts to set its charges at a level that is affordable for the users and competitive with similar services either within the city or outside the city. It is used where market rates are not sufficient to meet the full costs of the service. The balance is funded from rates.
8. **Residual** indicates that a portion of funds comes from this source. It reflects that in some circumstances there are constraints on council charges, or that the alternative revenue source may include enforcement revenue which is imposed to achieve compliance and may not always cover the costs of enforcement.
9. **Licence and enforcement fees** can be charged for some services. Licence fees may be set by the council or by regulation, and may not always cover the full costs of the service. Enforcement fees are charged to achieve compliance and do not necessarily meet the full costs of the enforcement activity.
10. **BID** are targeted rates applied to Business Improvement Districts within the city.

Bases for selection of mechanisms to fund operating expenses

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General rates is used to fund those services where the council believes there is a public benefit even though it may not be to the whole community. It typically funds "public goods" for which there is no practical method for charging individual users as the benefit is wider than just specific users. Our analysis of benefits indicates that there is no difference in incidence between multiple targeted rates and a differentiated general rate. General rates fund a range of services which are used by individual ratepayers to varying extents. The council

Revenue and Financing Policy

uses the general rate rather than a number of targeted rates in order to achieve a simpler rating structure. That simpler structure makes it easier for ratepayers to understand how they are being rated and it is also simpler and cheaper to administer. Rates are regarded as a tax which funds the collective community benefit rather than be any form of proxy for use of a service. Differentials are only used to ensure that other rates mechanisms do not alter the incidence in rates between the major rate payer groups. The rating policy (page 87, volume2) contains more information on rates.

Targeted rates are also used to fund community benefits and wider public goods. A targeted rate means a rate to be used exclusively to pay for that operating expense. It is used in circumstances where the council believes that the benefits from the services are such that the principles of a general rate approach (noted above) are not sufficient and that they should be targeted to a particular beneficiaries group. It is also used where the council considers that the level of charge is outside council's control and the extent of the impost should be clear to the community.

Grants and subsidies are used where they are available.

Borrowing is not generally used to fund operating expenses, but is used as a tool to smooth out major lumps in the capital replacement and acquisitions programme. The council may choose to borrow for an operating expense to give a grant to a community organisation that is building a community facility.

Income from dividends, interest and net rental income is used to offset the cost of provision of other services. Income from interest and dividends is included as revenue in the Investments and governance activity. This revenue is applied to councils general purposes. Income from rental of property is applied to the activity which is the primary user of a facility, if the property does not have a primary use but is held for commercial or strategic purposes the rental is included investments and governance activity, and is applied to general purposes.

Licence Fees are charged where they are available as a mechanism. They are set as for user charges but may have constraints on the level of the fee. These constraints are established under various legislation.

Enforcement fees are charged when possible. The purpose of the fee is to promote compliance rather than to raise revenue, at times enforcement fees will recover the full cost and at other times it will not depending on the level of compliance and also the extent to which the charges are limited by statute or the courts.

Funding of capital

Rates in all forms will be used to fund an ongoing replacement programme and may be used to fund a portion of capital acquisition work. This will be balanced against the affordability for the current ratepayers and the extent to which a capital replacement or acquisitions programme is even over the period of the plan. Over the period of the plan the council will get to the point where asset renewals are being met from operating revenue, and also a contribution is being made to levels of service and growth capital.

Borrowing will be applied to capital works subject to the preceding statement on the use of rates. The council views debt as a smoothing mechanism and a means of achieving equity between time periods. However the council does not have an unlimited capacity to borrow and the community does not have unlimited capacity to service those loans into the future. Therefore, the council adopts a prudent approach to debt and its capital programme to ensure that the burden of debt and the interest cost does not place an impossible burden on the community. In doing so the council is conscious of its peak debt and its ongoing funding stream for debt servicing and work programme.

In the early years of the plan the council is borrowing to fund asset renewals. This is being done to achieve a balance between the level of rates rises and the sustainability of service levels. In the later years of the plan the council achieves sustainable funding and borrows for part of the level of service and growth capital works. This is outlined in the Prospective Funding Impact Statement. (Page 12, volume 2)

Proceeds from asset sales may be used to fund capital works or repay debt. The preferred option will be for debt repayment with any new works funded from new debt draw down. This method is favoured due to its transparency and the neutral effect it has on rating. There is no major planned asset sales programme over the period of this plan, but assets which are no longer required for strategic or operational purposes may be sold.

Development and Financial contributions The Manukau community is growing at the rate of 1.9% per annum. That growth drives a significant portion of our capital work requirement to maintain levels of service to a growing community. As the cost of growth is driven by development the council considers that it is equitable that a development should make a contribution to the costs that are being imposed. The plan contains summaries of the development contributions policy (page 99 volume 2) and the financial contributions policy (page 109, volume 2). These charges under those policies are used to fund the portion of capital expenditure which relates to growth. In reaching the requirement for contribution any increase in level of service or renewal of asset is identified and funded from other funding mechanisms. The council has a development contributions policy and a financial contributions policy to obtain contributions to fund the infrastructure required due to city growth. The infrastructure includes roading, transport, growth centre development and community infrastructure. The proceeds from these policies are applied to capital works within the transport, storm water, leisure, libraries, and parks activities.

4.4 Policy on Development Contributions and/or Financial Contributions

A sensible analysis of powers to assess development contributions needs to be founded on an understanding of what development contributions are based on the latest jurisprudence.

The judgement of Potter J in the recent High Court decision in *Neil Construction and Others vs North Shore City Council* held that

> *'Development contributions are not a revenue tax which may be imposed to balance a council's budget, they are more in the nature of a charge, tied to the expenditure required of a council for capital works to support infrastructure incurred by a development or developments, although they fall short of specific cost recovery as in the case of user charges.'*

Put simply the legislative powers to assess development contributions establish these powers as being more akin to a charge to fund a specific set of infrastructural needs. In establishing how these needs will be funded local authorities are required to work through the *section 101(3)* analysis and consider community outcomes, beneficiary pays and intergenerational equity.

While development contributions are viewed as a charge to fund the cost of providing infrastructure to service growth your local authority cannot make the leap in logic from that to loading all of the cost of providing infrastructure onto the developers. Do not assume that any such capital work automatically generates benefits only to the new residents. In the Neil case Potter J actually found fault with the revenue and financing policy i.e. in the way the council had applied and documented *section 101(3)*.

A local authority must adopt a policy on development contributions and/or financial contributions, regardless of whether it has decided to assess:

- development contributions under the Act or
- financial contributions under the *Resource Management Act 1991* or
- neither.

The policy has to include the following information:

- the capital expenditure that the local authority expects to incur as a result of growth and identified in the LTP
- the proportion of that capital expenditure that will be funded from development contributions, or from financial contributions, and from other sources of funding
- the reasons for choosing development contributions and financial contributions linked back to the revenue and financing policy and the requirements of *section 101(3)*
- a list of activities or groups of activities that will be funded by a development contribution or a financial contribution and the total amount of funding from these sources in each activity.

A local authority that is not proposing to use these sources must still identify its capital expenditure and why they will be using other sources.

Those using either development contributions must identify why and provide the information required by *section 201* and *section 202* including:

- a schedule of development contributions payable in each district in respect of reserves, network infrastructure, and community facilities (and in relation to each activity or group of activities for which a contribution will be sought)
- the `trigger' that gives rise to the development contributions (resource consent, building consent, authorisation for a service connection).

If financial contributions are required then the local authority must include a summary of the *Resource Management Act* with respect to financial contributions (and the full list of provisions must be kept available for public inspection).

If development contributions will be assessed then the local authority has to make a copy of the full methodology for calculating them available for public inspection.

Don't forget that this is also a policy on financial contributions under the RMA and therefore:

- this policy needs to align with whatever documentation you have prepared that relates to the RMA (if you are seeking these contributions)
- your revenue and financing policy will also need to discuss financial contributions (and don't forget that these can be used for operating needs), and
- at the minimum your policy on development contributions or financial contributions will need to explain why you are not seeking financial contributions.

4.5 Liability Management

Your local authority is required to adopt a liability management policy. When read in conjunction with the financial strategy, a liability management policy represents your local authority's 'house rules' for borrowing. A liability management policy also serves an important function for those local authorities that wish to issue debt on securities on the retail market – it takes the place of some disclosures that would otherwise go in the prospectus.

4.5.1 Legal Requirements

The liability management policy has to contain the following information:

- *interest rate exposure policy* - this includes the following:
  - the percentage of fixed vs floating rate debt
  - what are acceptable borrowing facilities or incidental arrangements for hedging of interest rates
- *liquidity policy* - this includes the following:
  - available lines of credit
  - debt maturity profile
  - other working capital requirements.
- *credit exposure* - should internal limits for credit exposure concentration be indexed to credit rating systems such as Standard and Poors or Moody's (this is generally only worth the expense if your local authority has borrowings in the tens of millions)
- *debt repayment* – what are your policies around rollover of debt when it comes due for repayment
- *acquisition of new investments.*

4.5.2 Good Practice for Liability Management Policies

The underpinnings of your liability management policy should flow from your revenue and financing policy. In effect, your liability management policy is one of the mechanisms your local authority has for implementing your policy judgements about intergenerational equity.

This is a policy where its main purpose is to set out the circumstances in which you will borrow and how you manage the risks involved in borrowing. It is not a policy that requires detailed disclosure

of procedures, though as a document that can be adopted by resolution it can include more of the mechanics of treasury management than it previously had to.

Some policies can be quite technical in nature and are therefore quite difficult for even the reasonably informed reader to understand. Borrowing is something the media and the public do pay attention to, and an area where the policy intentions of your local authority can be easily misinterpreted. The level at which the statutory disclosures are pitched is not necessarily going to require a lot of technical information, financial terminology and the like. Where technical material is necessary, the terms should not only be defined in lay terms but also the relevance and importance should be explained.

The intent of the borrowing provisions is that liabilities (term debt in particular) would be managed globally rather than in a series of 'jam jars'. The requirement to undertake *section 101(3)(a)* analysis at activity level does not mean that borrowing must be done activity by activity, or project by project. Managing a number of separate loans may be necessary for:

- legal reasons (for example those wishing to offer a lump sum contribution option will find they are tied), or
- practical reasons (some communities prefer that debt be managed in this way – usually this is linked to the presence of ward based rating and accounting systems).

There, are however costs in managing your borrowing in this way.

4.6 Investment Policy

4.6.1 Legal Requirements

The more strategic elements of the investment policy have been moved to the financial strategy – including the objectives for holding investments and the introduction of a mandatory requirement to set targets for expected returns[11]. Having seen information in the financial strategy about your investments and why you hold them, the investment policy then provides readers with assurance that your local authority has proper procedures in place for trading off risk and return. With this in mind the required disclosures in an investment policy are:

- *mix of investments* – some cross-referencing between this part of the investment policy and the liability management policy is probably desirable in considering factors such as the mix of investments of differing maturities, risk profiles
- *risk management* – details of how risks are identified and managed. Risk includes the normal "business risk" and currency risk (for investments denominated in foreign currency)
- *procedures for management and reporting on investments* – local authorities should consider the benefits of managing liabilities and investments together so as they can jointly report on these activities. These should ideally be linked in with the objectives specified earlier in the policy.

4.6.2 Good Practice for Investment Policies

You should give a general description of the process for managing and reporting your investment.

[11] This change was also accompanied by the addition of a new principle requiring that local authorities periodically assess the risk and return from equity investments and commercial activities, and satisfy themselves that return outweighs risk.

With the risk-return tradeoff in mind your policy may need to refer back to the contents of the financial strategy. Not providing this information leaves the reader with an unbalanced picture, that is, much of the information in an investment policy focuses on risk without any solid information on return to balance the equation.

4.7 Remissions and Postponement Policies

In this section we discuss the two optional policies, the statutory requirement to adopt a remission and postponement policy on Māori freehold land is discussed in section 4.8.

Remission of rates involves reducing the amount owing or waiving collection of rates altogether. Postponement of rates means that the payment of rates is not waived in the first instance, but delayed until a certain time, or until certain events occur.

Both these policies are optional, but you will be unable to do things as significant as postponing rates for economic development purposes, or as mundane as waiving a penalty on an overdue rate without a policy in place. Remitting or postponing rates outside of the circumstances permitted in your policies, is unlawful, and could leave the elected members or staff facing an 'unauthorised loss' (as defined in *sections 43-47* of the *Local Government Act*). Both policies must clearly state what the objectives of each policy are, and the conditions or criteria that apply to each.

Remission policies are primarily used to:
- simplify the day to day administration of the rating system (for example almost all local authorities have a policy allowing for the remission of penalties and/or balances that are uneconomic to collect)
- ameliorate the results of the change in primary liability from occupiers to owners (for example some, generally rural local authorities, have policies allowing them to remit fixed rates on properties that are used jointly but in different ownership)
- provide assistance to groups deemed to be 'worthy causes' such as sporting and cultural groups, or heritage properties.

Fewer local authorities make use of postponement powers – the overwhelming majority that use these powers do so as a means of dealing with financial hardship, with a much smaller number using them as a means of promoting economic development.

The following are useful principles to keep in mind when developing a policy on remission and postponement policies. These policies should be:
- *linked to one or more of the community outcomes and other strategic priorities* - of your local authority that is these policies should be a tool for promoting community wellbeing. Your remission and postponement policies need to be designed specifically for your local authority – if borrowing the policies of other local authorities be sure they were designed with the same objectives in mind
- *complementary to the other programmes provided by your local authority* – when considering whether or not to remit or postpone rates your elected members should consider whether forgoing revenue is the best means of achieving the objective. Sometimes the discipline of having to approve a grant (that is actually writing out the cheque) can act as a good way of restraining 'generosity'
- *generic* – policies should be phrased in terms of categories of rating units rather than referring to a particular rating unit. Inventing a policy to suit an individual property should be done only in truly exceptional cases

- *frequently reviewed* - so that your local authority can satisfy itself that the circumstances in which a rating unit qualifies for an exemption still apply. This might be through inspection, requiring reapplications and the like, and
- *clear* - ambiguous policies will create future issues. This is particularly important because the *Rating Act* does not give you discretion over your postponement policy – if a rating unit meets the criteria in the policy and the owner applies you must postpone the rates.

Elected members must make the decision to remit or postpone rates – unless they have resolved to delegate this authority. Take care that the policy allows for the delegation and that the elected members have so resolved. If this is not done elected members will need to make a specific decision on each remission or postponement - even the day to day administrative waivers.

Don't forget that the *Rating Act* obligates you to disclose in your accounting documents:

- the rates your local authority remits as having been paid on behalf of the ratepayer in accordance with the relevant objective in the remission policy, and
- disclose the net cost of any postponed rates your local authority (i.e. the rates and any postponement fee) as having been paid on behalf of the ratepayer (this applies only where postponement fees are not charged or where the fee does not cover the financial and economic costs of the postponement).

While local authorities have recorded these in the general ledger etc, the requirement also includes disclosure in the financial statements. This appears to be a provision honoured more in the breach than in the observance. As far the financial statements go the disclosure is not particularly lengthy or complex – a simple table suffices e.g.

Category	Amount ($000)
Remissions to sporting and cultural groups	$123
Remissions of penalties	$456
Remissions on contiguous properties	$246
Total remissions	$825

4.8 Māori Freehold Land

4.8.1 Legal Requirements

A policy on remission and postponement on Māori freehold land is a *mandatory* policy. The required content of the policy extends only as far as Māori freehold land. This is defined as 'land whose beneficial ownership has been determined by the Māori Land Court by freehold order.' There must be a court order somewhere in the Māori Land Court records that confers the status of Māori freehold land upon the land. Your local authority is within its rights to request proof that a block of land has this status as part of verifying eligibility for remissions or postponements, and refuse to remit/postpone without such proof.

This definition makes it clear that Māori freehold land relates to a category of land rather than a category of owner. The factors that make Māori freehold land 'different' relate to its different

tenure arrangements, the restrictions on alienability, and the fact much of it cannot be put to economic use.

The requirement is to have a policy on the remission and postponement of rates on Māori freehold land. Provided that your local authority can demonstrate it has considered the objectives and criteria of *schedule 11* of the LGA, a policy of no remissions and postponements is in accordance with both the letter and spirit of the legislation.

In developing a policy your local authority is required to consider the objectives set out in *schedule 11* of the LGA:

- supporting the use of the land by the owners for traditional purposes
- recognising and supporting the relationship of Māori and their culture and traditions with their ancestral lands
- avoiding further alienation of Māori freehold land
- facilitating any wish of the owners to develop the land further for economic use
- recognising and taking account of the presence of waahi tapu that may affect the use of the land for other purposes
- recognising and taking account of the importance of the land in providing economic and infrastructure support for marae and associated papakainga housing (whether on the land or elsewhere)
- recognising and taking account of the importance of the land for community goals relating to
    - the preservation of the natural character of the coastal environment
    - the protection of outstanding natural features
    - the protection of significant indigenous vegetation and significant habitats of indigenous fauna
- recognising the level of community services provided to the land and its occupiers, and
- recognising matters relating to the physical accessibility of the land.

Your council must consider:

- the desirability and importance of the above objectives
- whether, and to what extent, the attainment of any of these objectives could be prejudicially affected if there is no remission of rates or postponement of the requirement to pay rates on Māori freehold land
- whether, and to what extent, the attainment of any of these objectives is likely to be facilitated by the remission of rates or postponement of the requirement to pay rates on Māori freehold land, and
- the extent to which different criteria and conditions for rates relief may contribute to different objectives.

Policies that say 'there is no (or little) Māori freehold land in our district[12]' or 'our policy is not to remit or postpone rates on Māori freehold land' with no other discussion will struggle to demonstrate that *schedule 11* has been considered. At the minimum your policy should be state the matters in *schedule 11* and pointing the interested ratepayer in the direction of documents that show how your local authority considered those matters.

[12] Properties move into and out of Māori freehold land status all the time, this statement may not necessarily even be an accurate reflection of the true state of affairs.

4.8.2 Good Practice for Remission and Postponement Policies on Māori Freehold Land

There is no statutory requirement to show how your local authority has considered the *schedule 11* objectives in your policy. If you elect to keep your actual policy short, then you will need to have supporting documentation on hand that does show that your local authority has given the issue the required consideration. Failure to do so could leave your policy open to judicial review.

The same requirements for transparency and rationale apply to this policy as apply to other financial policies. It is not enough to state in supporting documents that your council 'does not consider that not having a remissions or postponement policy will impede the achievement of the objectives' or 'this objective is not considered important within the ABC district council'. Your documentation should explain how and why your local authority reached that conclusion.

Your documentation should work through the objectives and matters systematically and comprehensively. There are a number of templates that will provide for systematic consideration, but many are from those local authorities that have significant amounts of Māori freehold land. A simple format that should ensure nothing gets missed is shown in Figure 4.3.

Figure 4.3: Template for Consideration of Schedule 11 Objectives and Matters

Objective 1: Supporting the use of the land by the owners for traditional purposes
a) Importance
b) Can rate remission or postponement facilitate achievement of this objective for all Māori freehold land ? If so how?
c) Is there any subset of Māori freehold land in your district where the analysis in b) does not hold? If so, what and why ?
d) Will a remission policy be applied in recognition of this factor? Why or why not?
e) Will a postponement policy be applied in recognition of the factor? Why or why not?
Objective 2: Recognising and supporting the relationship of Māori and their culture and traditions with their ancestral lands
a) Importance Etc …

Of course, many of the objectives will be interlinked, for example a particular block of land cannot be developed easily if it has no road access

Not all Māori freehold land is the same. There is:

- different use – some may be papakāinga and/or have other occupied dwellings, some may be wāhi tapu or other sites of spiritual significance, some may be closer in use to Department

of Conservation land (e.g. some mountain and hill ranges, swampland);
- accessibility – some land is landlocked i.e. no road access
- ownership arrangements – most Māori freehold land has large numbers of owners (in some cases running into the hundreds. This has implications for the ease with which some land can be developed and may influence your consideration of these matters.
- rating history – depending on the policies applied by previous local authorities, some land may have considerable levels of arrears built up, others may have little or none. This also may have implications for the ease with which land may be developed.

Those local authorities with a more significant volume and range of Māori freehold land may find that the fourth of the matters (different conditions and criteria) may assume more importance than those in other circumstances. Local authorities of any type may also find the good practice principles in Box 4.1 of some assistance. These have been developed as good practice by Te Puni Kōkiri – all, some or none may be relevant to your local authority.

Box 4.1 Te Puni Kōkiri – Good Practice Principles for Remission and Postponement Policies on Māori Freehold Land

1. *Certainty*: that both owners of Māori land and local authorities can be confident of an outcome if specific conditions are met and that decisions will endure over time so long as the circumstances remain unchanged
2. *Effectiveness*: that Māori land issues are addressed as fully as possible recognising a balance between the perspectives of owners of Māori land and local authorities
3. *Compliance costs:* that compliance costs to both local authorities and owners of Māori land are minimised
4. *Equity*: that Māori land issues are addressed in a fair manner by ensuring comparable treatment of owners of Māori land and local authorities in comparable situations
5. *Flexibility*: that situations are able to be considered on a case by case basis where appropriate in order for situation specific factors to be accounted for
6. *Simplicity*: that the process is straightforward and is easily able to be understood by owners of Māori land and local authorities
7. *Transparency*: that the process; in terms of rationale, rights and responsibilities; is clear and well understood by both local authorities and owners of Māori land.

Of course, community wellbeing should also play a role in the development of your policies. If you have a significant volume of Māori freehold land which could be developed, it may well be that partial remission of arrears and/or postponement of rates for a period of years may provide incentives to develop land (improving collection in future).

And last, but not least, your policy on remission and postponement of rates is an opportunity to help build your relationships with tangata whenua in your community. This is a process that should be worked through jointly rather than waiting for the special consultative process on the LTP, especially if there is a significant level and/or significant range of types of Māori freehold land in your community. The process is as important as the content of the policy.

Things to Remember: Funding and Financial Policies

1. Funding and financial policies are an important part of the LTP – they help the community understand not only what they will be expected to pay, but how they pay and when they will pay.

2. Funding and financial policies cannot be developed in isolation from the two step funding process of *section 101(3)*. That process is a sequential two-step process. The first step includes consideration at activity level of the rationale for service delivery, beneficiary pays, exacerbator pays, intergenerational equity, and the costs and benefits of separate funding. Once the first step has been completed, consider the impacts on social, environmental, economic and cultural wellbeing.

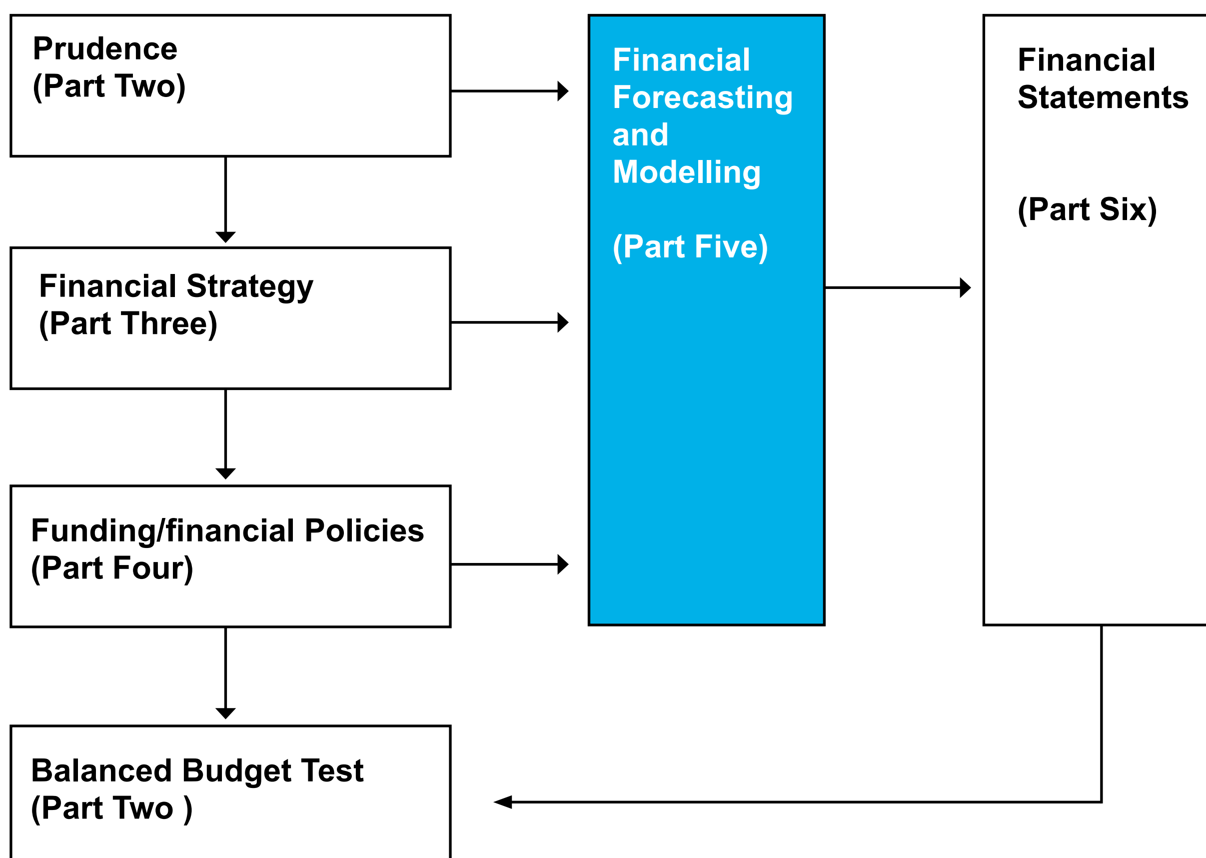
3. The RFP is now the only *section 102* policy that must be included in the LTP. However an understanding of the other policies may aid some users so your local authority should consider at least including summaries of the other policies in your LTP.

4. While your RFP must show how your local authority complied with *section 101(3)* this does not necessarily mean a blow by blow account of all of the analysis that was undertaken. Common approaches may exist to funding activities that may offer opportunities for shorthand descriptors. If using this approach be sure to clearly define the descriptors and the circumstances in which they apply. And don't forget that the RFP must separately explain your selection of funding sources for operating and capital expenditure.

5. The strategic content of the borrowing management and investment policies has been moved to the financial strategy – these policies are now largely documents that describe how your local authority manages risk.

6. Having a policy that discusses remission and postponement of rates on Māori freehold land is a mandatory requirement. Your policy should flow out of your consideration of the objectives set out in *Schedule 11* of the Act, which may lead you to not remit and postpone rates on this land at all.

PART FIVE: FINANCIAL FORECASTING AND MODELLING



Your financial forecasts provide the ratepayer with information about the council's future funding needs across the life the LTP. These forecasts form the underpinning of the numbers in your financial strategy and are a critical part of the assessment of prudence.

Your forecasts are the outcome of a process of modelling the impact of your intended policy settings. Modelling is also useful day to day decision-making tool and essential to test scenarios and combinations and to inform the development of the financial strategy and the "do-ability" of the combination of service strategies and other policies. Good modelling should enable:

- evaluation of risk and the importance or impact of changes in key assumptions.
- identification of the impact of alternatives eg different levels of service and
- evaluation of the impact of changes in financial policy.

A robust financial model is only as good as its two main components:

- the assumptions, and
- the modelling tool.

5.1 Forecasting Assumptions

A forecasting assumption is defined as something your local authority accepts as being true for the purposes of future decisions and actions.

Forecasting assumptions are one of the building blocks of the financial forecasts in your LTP. This is an area 'armchair expert' readers will pay attention to, and their views on the quality of the assumptions will shape their views on the LTP. The financial reporting standard[13] that covers prospective financial information places you under an obligation to prepare financial forecasts based on the best information available to you at the time the forecasts are prepared.

Therefore your forecasting assumptions must be:

- realistic
- evidence-based - especially where assumptions are outside industry norms
- consistent with each other
- applied consistently across the LTP (unless there is good reason not to and the differences in treatment and reason for the difference are both disclosed in the LTP).

Your local authority will probably have two levels of assumptions. First, corporate level assumptions or those that are organisation wide and applicable to all activities of your local authority. Some of the really important assumptions may be significant factors for disclosure in the financial strategy. These should be prepared centrally by your LTP project team – in consultation with finance and activity managers[14], and put to decision-makers for decision (the Chief Executive and their direct reports) and information (the elected members). This should happen soon after the LTP project starts – and before activity managers begin reviewing levels of service.

Second, there will be assumptions that are relevant to individual activities. Most probably these will be compiled by the individual activity managers, from existing information sources, but should also be reviewed centrally by the Project Team. Two sets of assumptions that the act specifically mentions as requiring identification in the LTP include:

- the useful lives of significant assets[15], and
- sources of funds for replacement of significant assets[16].

The terms 'significance' and 'significant' are defined in the Act as relating to matters that have a high degree of importance to or consequences for

- the wellbeing of the district/region, or
- persons particularly interested in or affected by the matter, or
- the capacity of your local authority to perform its role, or cost of it doing so.

Those forecasting assumptions that qualify as 'significant' will most probably qualify for that status through the third of these tests. Look out for any of the following:

- a material effect on your overall revenue
- a material effect on your overall operating expenditure
- a material effect on your ability to finance and fund future operating expenditure and capital expenditure as outlined in the LTP

[13] FRS 42 – Prospective Financial Information

[14] There may be advantages in working with neighbouring territorial authorities and the regional council to determine a combined 'world view' on some of the key forecasting assumptions – especially around demographic and economic data.

[15] The 2004 Office of the Auditor-General publication OAG Guidance for the Assessment of Significant Forecasting Assumptions suggests that a GAAP compliant policy on depreciation of assets will satisfy the requirement to disclose useful lives. Other circumstances that auditors were asked to watch out for were:

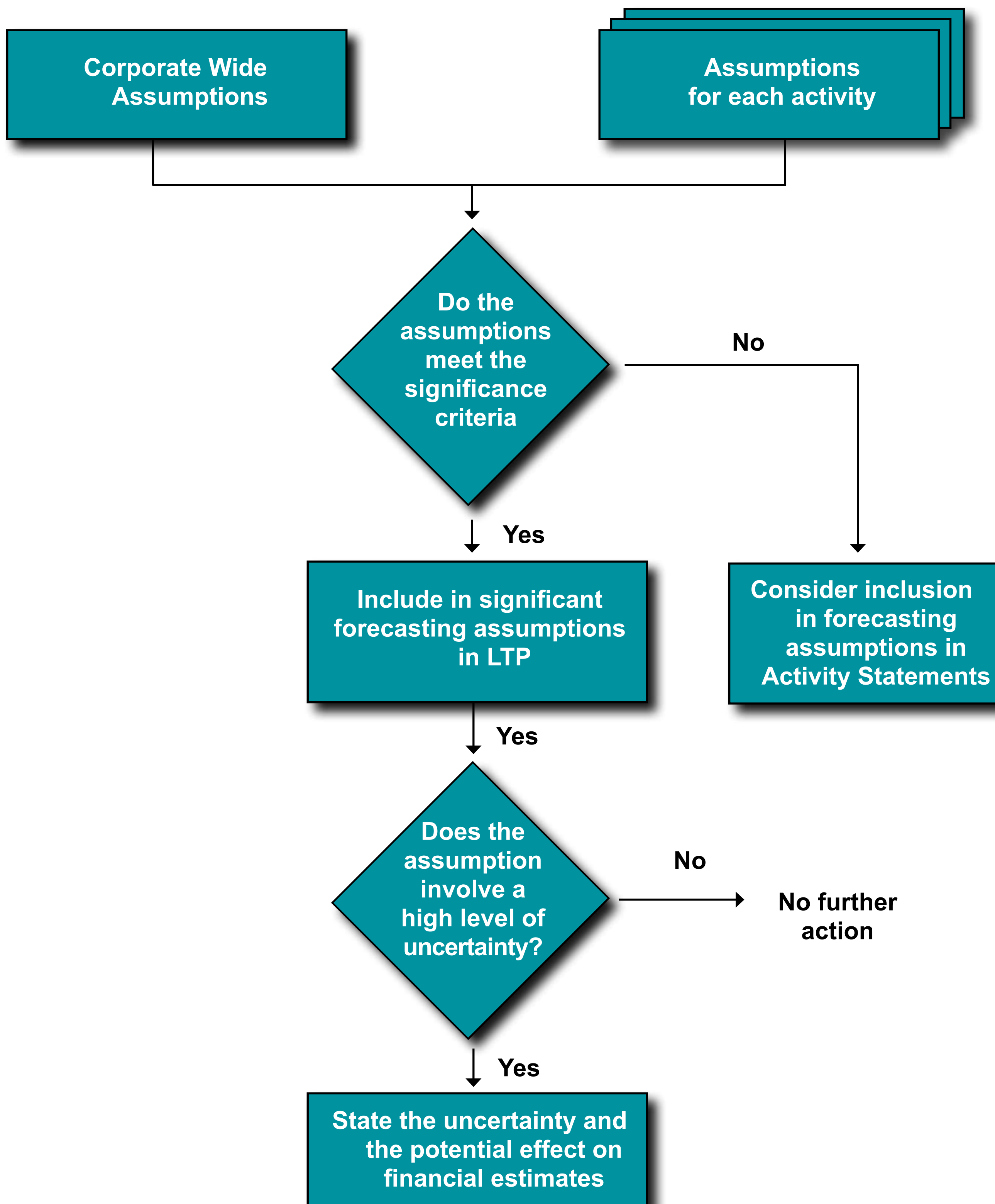
- the presence of vested assets not yet incorporated into an asset management plan
- assets owned by the community but likely to be replaced by the council at some point in the life of the LTP (mostly user funded water schemes and private roads)
- assets which will not be replaced.

[16] OAG, 2004, also indicated to auditors that the requirement to disclose this information could be met by a revenue and financing policy, provided it met the requirements of *sections 103* and *101*.

- a material effect on assets employed by your local authority, particularly strategic assets
- a material impact on the overall ability to deliver intended levels of service.

Figure 5.1 shows one process for determining whether a particular assumption is significant.

Figure 5.1: Determining the Significance of Assumptions



What Assumptions Might You Need?

The following assumptions probably fall into the 'must have' category (those in italics are statutory requirements):

- *useful lives of significant assets* (while disclosing these in activity statements complies with the legislation, this information may be more logically presented with other assumptions)
- depreciation rates
- *sources of funds for replacement of significant assets* (with similar caveats about the logical place for disclosure as with useful lives)
- projected growth/change factors (including decrease where relevant)
- cost change factors (don't forget that local authority cost structures are quite different from the CPI)[17]. In an environment where key input prices can change rapidly, assuming away cost change can lead to material understatement of future funding needs, especially in the later years of the LTP, and create an impression that services are more financially sustainable than they really are
- exchange rates (especially if you have a significant programme of acquisitions of assets or purchases of services from overseas)
- subsidy rates (eg New Zealand Transport Agency, vector control)
- revaluation of significant fixed assets
- *assumptions regarding return on investments – including deposit rates and expected dividends and other returns from assets*
- interest rates on borrowing
- resource consents – timing and likelihood of renewal, and the terms of renewal.

Depending on the circumstances your local authority finds itself in you may also need assumptions around:

- other forms of income
- the consequences of particular policy decisions eg sales/transfers of assets, the establishment of particular collaborative initiatives, levels of service.

Information Sources

Information for assumptions could be sourced from (this list is not exhaustive)

- your previous LTP
- Reserve Bank and trading bank forecasts (in respect of interest rates)
- Statistics New Zealand
- growth projections for population (both in terms of the numbers and the composition of the population) households, economic activity, and rating base
- historical trends (such as the trend of decreasing people per household)
- asset management plans (useful lives of assets)
- assessments of water and sanitary services
- the district plan or regional policy statement (land use patterns)
- governance structures (representation arrangements)
- Land Transport strategies (subsidies)
- Statements of Intent (for CCOs)
- growth strategies
- property market trends (for development contributions)
- other local authorities

[17] Don't forget that SOLGM and LGNZ commission BERL to produce 10 year rolling forecasts of key local government cost indices. The most recent (October 2010) set of forecasts as of this writing can be found here.

- accounting policies and asset valuations
- asset/activity management plans (demand levels), and
- existing and known future government policy.

Reviewing Existing Assumptions

Most local authorities have now prepared at least three LTPs and should be reviewing assumptions as opposed to developing a new set from scratch. A review process should answer these questions:

- is the assumption still a necessary one? Why or why not?
- do the statements of fact in the assumption need to be amended? If so, why and how?
- does the assumption need to change status, e.g. is it something that should become a significant assumption?
- are there matters in the present environment or projected future environment that need new assumptions.

This review process should be done in at least two points in the LTP process:

(a) at the commencement of the LTP project to inform activity managers etc

(b) at a point that lies between the preparation of the "first cut" of an LTP, and its presentation to council.

Where assumptions are particularly significant and/or likely to change during the process you may need to monitor these on an ongoing basis. For example, in 2009 several high growth local authorities discovered that the slowdown in development in their districts was far greater than anticipated, but did not discover this until after they had completed consultation on their statements of proposal. Where data that underpins assumptions is sourced internally, as some growth data will be, systems for the timely capture and sharing of the information may be needed.

Disclosing Significant Assumptions

Once you have identified an assumption as significant your local authority will have to disclose the following information in the LTP:

- the assumptions themselves
- where there is a high level of uncertainty then the uncertainty, and
- an estimate of the potential effects of that uncertainty on the financial estimates.

Along with the Act's requirements, Financial Reporting Standard 42: Prospective Financial Statements requires that prospective financial statements contain the information necessary so that the user can appreciate the degree of uncertainty and the effect of that uncertainty for **all assumptions** included in the prospective financial statements. Therefore, the combined effect of clause 17(a) and FRS 42 requires councils to disclose the implications of the uncertainty for **all** assumptions.

Your assumptions should be phrased as assumptions not as statements of fact. For example, when disclosing assumptions around resource consents for key services discuss the conditions of a new consent, or the impact of not getting a consent as opposed to just stating the consent date.

Disclosure of the significant forecasting assumptions and the risks around these is one of the key pieces of information that informed readers will use to make judgements abut the robustness of the plan. Good disclosures help your local authority manage expectations and provide a tool for explaining the reasons why the 'real world' is different from that which you forecast when preparing the plan.

In our observation, most local authorities could improve their disclosures around their significant forecasting assumptions. Most identify their assumptions well, many also provide an assessment of the degree of risk, but relatively few clearly state what the impact of the non acheivment of the "high risk" assumptions might be, and as far as we are aware no local authority attempts to quantify the impact.

Local authorities generally indicate whether forecasting assumptions have a high/medium or low level of risk but do not explain what these terms mean for the reader. Usually these terms will be associated with an assessment of the probability of the reality being materially different than that forecast. Whatever your basis for determining risk, it should be disclosed (most logically either as a footnote or frontispiece to the other disclosures around assumptions).

Your assessment of the impact does not need to be precise. Ranges or statements such as "for each 0.1 percent reduction in the rate of growth, development contribution revenues will fall y percent" are acceptable approaches to quantifying degrees of risk. Much of this type of information can be sourced from the modelling of the various options and "what if" analysis that you've done in preparation of the LTP. Figure 5.2 shows one format for presenting significant assumptions to the community - this format presents the information clearly in a compliant manner, but could be further improved with some quantification of the impact, and some disclosures around what the assessment of risk actually mean.

Forecasting Assumptions	Risk	Level of Uncertainty	Reasons and Financial Effect of Uncertainty
General Assumptions:			
Climate Change The Council has adjusted base financial projections to reflect the estimated impact of climate change related charges on the costs of electricity, natural gas and landfill emissions.	That changes in government legislation will result in charges and revenue that are significantly different from estimated impacts of the Emissions Trading Scheme under the previous government	Medium–High (years 2–10)	Emission based charges are affected by external political and economic factors, most of which are outside of the Councils control and influence. The Council has estimated its costs and revenue based on assumptions contained within the Emissions Trading Scheme which, while currently under review, the Council deems to be the most reliable estimate available.
Significant Financial Assumptions:			
Inflation The Council has adjusted base financial projections to reflect the estimated impact of inflation.	That actual inflation will be significantly different from the assumed inflation.	Low–Medium Years (1–3) Medium–High Years (4–10)	Inflation is affected by external economic factors, most of which are outside of the Council's control and influence. Council's costs and the income required to fund those costs will increase by the rate of inflation unless efficiency gains can be made.
Inflation Rates Applied: Inflation rates have been estimated using the BERL "Forecasts of Price level Change Adjustors to 2019." The applicable rates are (shown cumulative):			While individual indices will at times vary from what has been included in this LTCCP, the Council has relied on the Reserve Bank use of monetary controls to keep inflation within the 1.5 to 3% range.

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Roading	1.000	1.030	1.059	1.084	1.110	1.135	1.161	1.188	1.217	1.244
Property	1.000	1.030	1.058	1.088	1.118	1.150	1.186	1.216	1.244	1.272
Water	1.000	1.030	1.059	1.088	1.123	1.156	1.196	1.233	1.273	1.315
Energy	1.000	1.023	1.050	1.082	1.113	1.150	1.187	1.227	1.269	1.313
Staff	1.000	1.027	1.055	1.081	1.108	1.136	1.165	1.202	1.235	1.273
Other Expense	1.000	1.033	1.056	1.082	1.105	1.128	1.154	1.181	1.209	1.240
Other Income	1.000	1.030	1.061	1.093	1.126	1.159	1.194	1.230	1.267	1.305

Figure 5.2: Disclosing Forecasting Assumptions and Risks – Wellington City Council

There is also a need to describe how your local authority is addressing changes in demand for services in your LTP. This includes reductions in demand. The requirement includes all strategies for addressing demand including the provision of additional capacity, techniques for demand management (leak detection services, peak hour charging, regulation, demand substitution etc). Further information on these strategies can be found in section 3.9 of the *International Asset Management Manual.*

5.2 Modelling Tools

Lets dispel a myth. A well-written spreadsheet model with appropriate documentation and controls may be an acceptable mechanism for modelling in an LTP. Spreadsheets can be provide a robust tool that is able to perform a variety of roles. They are a tool that is relatively easy to understand (which has particular relevance and importance if temporary/contract staff are brought in to work on specific issues).

But this level of familiarity can be the greatest weakness of spreadsheets. Financial modelling products go through a robust implementation programme and also testing. The structure of the product will require clear thought to the assumptions and variables to be loaded into the product and how they will relate to other parts. The product will also typically have access controls and control totals and verifications that it will run as outputs. In part, the familiarity with spreadsheet models can undermine these types of controls.

Other issues with spreadsheet models are that they:

- can become large and cumbersome – often successful models are dependent on large numbers of interlinked worksheets
- the worksheet becomes something written to meet the needs of the writers/operators rather than external use. This means that these can become difficult to audit and difficult for newcomers to understand
- typically spreadsheet models are only as good as the skill of the writer (and their enthusiasm)
- lack controls – in particular they can be too easy to change. Controls over formulas and ranges are often not in place. Input controls are difficult to implement. If you intend to use a spreadsheet we strongly recommend that you and your auditor take steps to provide assurance about the integrity and control checks at an early point in the process.
- mix output and layout with data and formulas.

So if not a spreadsheet then what? There are a number of different types of financial modelling packages that are commercially available. A good modelling tool should be:

- *simple to use* – non-technical users should be able to understand the tool and use it
- *flexible* – the best tools should allow the modelling of the impact of changes in particular parts on overall results
- *compatible with your financial management system* – in particular, information from the model should be able to be uploaded into the system
- *secure* – there should be controls on central assumptions and key inputs, and have version control. Only authorised users should be able to change key assumptions and update the model, and in the ideal there may be a hierarchy of access rights. This may require supplementary protocols or policies.

Two last points about modelling tools. If you are introducing a new financial management system for an upcoming LTP, the best time to do this is at least 12 months before adoption of the LTP. All new systems have unexpected 'teething problems' and building models from scratch always takes

time. Trying to do this alongside the volume of financial work that goes into an LTP, while meeting your day to day finance tasks, is an LTP bottleneck waiting to happen!

Second, be sure that your modelling package is sufficiently well-known that it has adequate after sales support, and financial contractors are generally familiar with the package.

Things to Remember: Financial Modelling and Forecasting

1. Your forecast financial statements will only be as good as the robustness of your assumptions and modelling tool.

2. An assumption is something that your local authority accepts as being true about the future. Most probably there will be two levels of assumptions – corporate level, and activity level. Corporate level assumptions should be prepared (or reviewed) by the LTP project team as soon as possible after the LTP project begins.

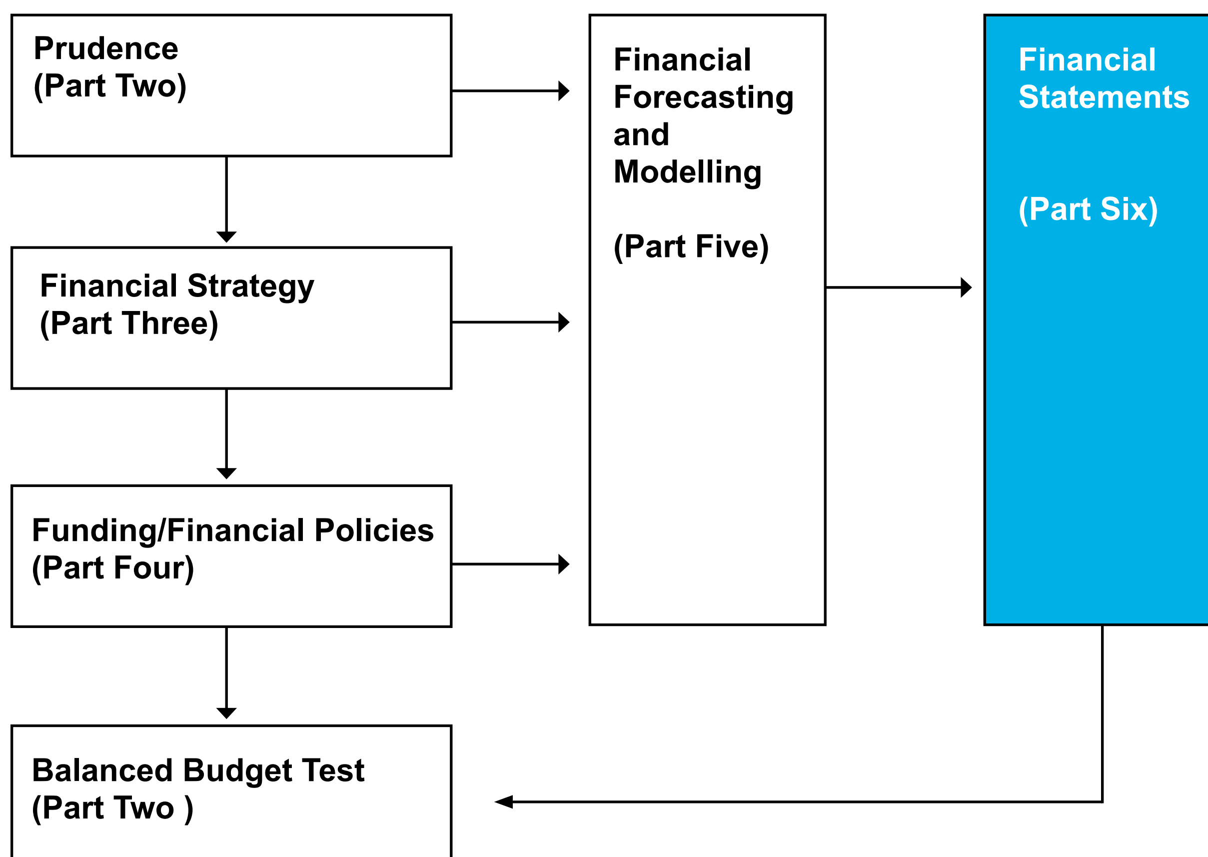
3. Your assumptions should be realistic, evidence based, internally consistent, and applied consistently.

4. Where assumptions involve a significant level of uncertainty then you need to disclose the uncertainty and the impact on the financials.

5. Your financial model will need good supporting documentation, good controls and be readily understandable to an outsider. It can be difficult to achieve this with spreadsheet based models.

6. If you need to implement a new system or modelling tool, its generally best to have the system bedded in by June of the year preceding the LTP.

PART SIX: FINANCIAL STATEMENTS



6.1 Why Are Financial Statements Important?

Financial information and/or statements form a critical component of the LTP. Consistency and effective communication of financial information aids in effective long-term planning. This part of the Guide discusses:

- the financial statements required under Generally Accepted Accounting Practice (GAAP)
- the funding impact statement as it applies at council level and group of activity level
- other non-GAAP requirements.

Well presented financial information/statements is an aid to the right debate – it lets the reader know what the cost of local services is and how that will be apportioned. Financial information must therefore line up with the remainder of the content of the LTP – and cannot be prepared in isolation from the rest of the process.

Financial statements:

- provide the basis for long-term planning by enabling an informed assessment of the financial sustainability of the bundle of service delivery and policy decisions (in other words they are a critical part of establishing that your long-term plan really is long-term)
- provide context to the right debate by communicating what services cost
- must be prepared hand in hand with all other facets of the LTP. The preparation of financial

statements must be carefully sequenced. This allows for sufficient time for the statements to be prepared (financial modelling) and to be strategically reviewed (quality assurance). Planning for the preparation of financial statements is an important part of *plan(ning) your plan*

- provide a basis for monitoring progress against your LTP through the preparation and review of annual plans, monthly internal and external financial information and annual reports. There is a financial aspect to the continuous plan.

6.2 Developing Financial Statements: Some Principles

All of the discussion on the various aspects of financial statements/information is underpinned by the following principles. These principles should also be applied in the preparation and use of financial information/statements in the LTP process:

- *integration of all aspects of financial information/statements* - all financial information must be prepared and presented in a manner that produces consistency and integration with all aspects of the rest of the LTP
- *clarity* – understandability of financial information/statements - all financial information must balance the requirement to comply with generally accepted accounting practice with the need to present clear and understandable information to the reader. This includes substitution of "jargon" with plain English explanations
- *transparency* – the right debate is clearly demonstrated and supported. The presented financial information should add to the reader's understanding of the key issues being presented
- *robustness* – completeness of financial information and compliance with standards in the preparation of financial information. The financial information presented must be complete, accurate and compliant with GAAP (except for the funding impact statement discussed later in this part). The financial information must withstand full scrutiny and audit whilst supporting the rest of the LTP and not confusing the messages presented
- *efficiency* – the right level of financial information/statements. There is a tendency to either overload the LTP with financial information or to keep the financial information to the bare minimum.

6.3 GAAP Financial Statements

Clause 12 of Schedule 10 requires that local authorities prepare a set of forecast financial statements. As local authorities are obligated to follow GAAP these statements include the following:

- statement of comprehensive income
- statement of changes in equity
- statement of financial position
- statement of cash flows
- statement of accounting policies
- explanatory notes.

The style, content and disclosures of the forecast financial statements are well established. They are governed by GAAP and must comply with New Zealand International Financial Reporting Standards (NZ IFRS). The forecast financial statements will reflect closely the results that will be subject to audit within the annual report.

The Act now permits regulations to add further disclosure requirements to GAAP. From 2012 all forecast financial statements must separately disclose:

- income from rates, development and financial contributions and from subsidies and grants
- the value of investments in council-controlled and similar organisations
- depreciation and amortisation for assets used directly in providing each group of activities

Rates and development and financial contributions represent the major sources of local authority income derived from coercive powers. Clear disclosure of these is necessary for accountability purposes.

A standard definition of rates has been adopted for financial reporting purposes. This is all rates income excluding metered water income. This definition is consistent with current statistical reporting practices (metered water income is excluded from rates in Statistics New Zealand data), consistent with emerging practice in financial reporting standards (ED 118 – Accounting for non-exchange transactions when implemented will distinguish between metered water charges, an exchange transaction, and other rates as non-exchange transactions), and reflects ratepayer experience.

In other words, the rate figure you report in financial statements includes general rates, targeted rates (other than metered water), uniform annual general charges and penalties. Lump sum contributions are expressly excluded from the definition of rates that appears in the Rating Act and therefore are also excluded from the rate figure that will appear in GAAP statements.

Apart from the treatment of metered water, this definition would also preclude the practice some councils follow of combining targeted rate income with other revenue sources as "activity income' and only reporting general rate income as "rates".

Subsidies and grants represent income that is dependent upon other parties. This should be separately disclosed from other local authority income as its continuity depends on the policies and practices of the donor parties rather than the local authority.

Councils are also required to separately disclose the combined value of their investments in council-controlled organisations (CCOs) and organisations that have the same characteristics as a CCO but are excluded from the definition of CCO by section 6(4) of LGA 2002. These include port companies and their subsidiaries, electricity businesses and energy companies. The reason for the separation is to make your local authority's liquidity position clearer to the community. Previous long-term plans often combined the value of these investments with more liquid cash and investment portfolio holdings. Many local authorities are reluctant to sell CCOs but may be more open to using cash and portfolio investments to fund their activities and projects.

Finally, local authorities are required to disclose, by way of note, the depreciation and amortisation expense for assets used directly in the provision of each group of activities. While depreciation is not an expense that directly requires funding, it is a proxy for the consumption of assets. Given the importance of asset management and funding in local government, recording the depreciation expense for each group of activities enables ratepayers to compare actual capital expenditure with depreciation, thereby getting an indication of whether a local authority is allowing assets to run down, or is building up assets.

Some specific observations about the Council-wide financial statements are:

- the statement of comprehensive income needs to separately disclose total interest expense, total depreciation and other expenses
- your council level FIS should demonstrate the linkage to the funding and financial policies.

The LTP must include comparative forecast financial information from the previous year's annual plan, and formatted in the same way as the forecast financial information in the LTP. This may involve recasting the previous year's financial information into the format adopted in the LTP.

Consolidated Financial Information

Consolidated financial estimates are not required by the LGA 2002. However external reporting (annual reports) must be prepared on a consolidated basis. Indeed there is an expectation that in complying with GAAP the financial statements would be consolidated.

Therefore serious consideration should be given to producing consolidated financial statements/ information within the LTP especially where significant service delivery is undertaken by subsidiaries and other organisations controlled by the Council.

Ideally, your local authority would consolidate financial statements where entities:

- deliver significant services on behalf of your local authority or
- their financial performance is an important part of your financial strategy (the first of the case studies in Part Two provides an example) or
- where consolidation adds value and provides a fuller picture of activity within the LTP.

If your local authority decides not to provide consolidated financial statements then the rationale for the non consolidation should be separately disclosed.

6.4 The Funding Impact Statement

Changes to the Local Government Act made during 2010 greatly strengthened disclosures around flows of funding into and out of local authorities. As a result FIS requirements now apply in two places in your LTP, Annual Plan, and Annual Report.

In each case the FIS is intended to make the sources and applications of local authority funds transparent to stakeholders. Changes to the FIS have been driven by an apparent concern that GAAP based accounting statements may not be that easy for stakeholders to follow, and that it is flows of funding that are most relevant for their needs. As a result, section 111 of the Act specifically excludes information in the FIS from having to adhere to GAAP. But the presentation of the FIS must follow formats laid down in the Local Government (Financial Reporting) Regulations 2011.

Council Level FIS

The council level FIS links your RFP and the annual setting of rates, fees, development contributions and the annual borrowing requirement. A council level FIS is a ten year statement that sets out the revenue and financing mechanisms that will be used in each year, and an indicative level or amount of funds to come from each mechanism. The FIS must now also show the planned application of funds in each year.

The funding impact statement should contain enough detail to:

- support the revenue and financing policy in providing predictable and certain estimates of future funding requirements
- help your residents and ratepayers understand the implications of the revenue and financing policy 'for them' i.e. what are the rates and charges they are likely to have to pay, and
- demonstrate that you have complied with your own revenue and financing policy.

Disclosures About Mechanisms

The required disclosures around rating mechanisms literally require all of the information you would put into a rates resolution except the actual level of the rate (the 'rate in the dollar', 'per property' and the like). Take care with this aspect of the FIS – defects in this aspect can invalidate all subsequent actions.

So for a *general rate* that information includes:

- the valuation basis (land, annual, or capital)
- differential categories (if any) and either the revenue sought from each category or an explanation of how the level of the rate that each category pays differs from the others (so, for example if your council has a target differential such as the commercial sector paying twice the rate in the dollar that the residential sector pays you would state that here), and
- details of the general amount of any uniform annual general charge and how it will be calculated (that is on a one per property or one per separately used or inhabited part of property, and if the latter then your definition of separate use or inhabitation).

For a *targeted rate* that information includes:

- the activity that the targeted rate will fund
- the categories of property that will be liable for the rate
- how the targeted rate will be calculated (which of the matters from schedule three of the Rating Act will be used as the basis for the rate, noting that there may be more than one, and indeed there may even be different bases for different categories of property)
- if differentials are being used, then the basis for the differential (from schedule two) and a statement of the relationships between the categories.

Your local authority is also required to disclose the level of every other revenue and financing mechanism it intends to employ in the FIS[18].

Where your local authority is intending to use a mechanism in more than one year (as typically it will with most mechanisms), then the mechanics of the rates need only be disclosed once (provided you specify the years in which your local authority will be setting that rate). If your local authority intends to change any of the mechanics for either a general or a targeted rate during the life of the plan (such as switching from land value to capital value or changing a differential) you will need to disclose that.

The council level FIS will contain a mix of financial information and non-financial information. There is no single 'right' way to present this information in the FIS, but many of the better 2006-16 FIS tended to follow a structure akin to the following:

- general rate disclosures
- targeted rate disclosures
- the rating models

[18] Readers are reminded that the actual setting of rates must be done by resolution of the council – relying solely on the FIS does not comply with the requirements of the Local Government Rating Act.

- other disclosures – borrowing, asset sales, development contributions, each fee and charge
- the financial component statement.

Disclosures About Sources and Application of Funds

Changes to FIS requirements in 2010 mean that the financial component of the FIS has taken on additional importance, and is a very different statement from those that preceded it. In particular the FIS:

- *should only include transactions between the local authority and other parties that happen through a monetary medium.* Transactions in kind (such as vesting assets) and revaluations of assets and liabilities are both excluded from the FIS. That also means depreciation and amortisation are excluded from the FIS
- *recognises transactions at the same point in time as under accrual accounting*
- *recognises transactions as operating or capital transactions according to the purpose for which the funds are obtained or applied.* Transactions that have significant elements of both capital and operating nature are classified as operating transactions. GAAP has no concept of income for capital purposes, so that income received solely for capital expenditure, such as roading subsidies for capital works and development contributions, contribute to an inflated operating surplus that confuses ratepayers. The FIS reduces this confusion by treating income for capital purposes separately from income for operating purposes
- *separate capital expenditure by driver* – that is to say that your FIS must separately disclose capital expenditure that is to service growth, that which is renewals, and that which is to increase levels of service. For the purpose of this disclosure requirement, projects that have elements of more than one driver e.g. a project that is say 25 percent growth and 75 level of service improvement component must be classified entirely as a level of service for this purpose[19]
- <u>*must*</u> *balance* – that is to say all sources of funds must be applied to some purpose (funds unspent in one year will be applied to an increase in investments or reserves).

The prescribed format for the financial component of the council level FIS is specified in financial reporting regulations. The prescribed format can be found in Appendix 6.1.

Budgeting and reporting on subsidies received for capital purposes may necessitate the creation of separate codes for subsides for capital purposes as opposed to subsidies for operating purposes. You may need to explain the changes to your roading engineers –
sometimes NZTA definitions of capital expenditure are different from GAAP definitions.

Rating Models

The other new requirement is that examples of the impact of rating proposals in *year 1 of the LTP* must be included if your local authority proposes to set and assess rates[20]. The requirement is that your FIS show a range of different categories of property and a range of different values.

We suggest that the selection and presentation of samples be kept as simple and understandable as is consistent with the purpose of the legislation. Some useful principles to apply when selecting the number of examples are:

[19] We urge caution with this– remember that your development contributions policy must specify all growth related capital, in a case such as cited in the example where the 25 percent would appear in development contributions policy, someone is bound to notice the difference! A reconciliation may be necessary.
[20] The Annual Plan FIS includes this information for the year covered by the Annual Plan.

- *logical rationale* – selection of the range of values should follow some consistent and explainable rationale. A starting point might be to select the either the average or median property value within a category and then select say the property at the 20th percentile and the 80th percentile (or 25 and 75). Whatever your selection is, explaining the rationale avoids perceptions that you have plucked examples from thin air
- *materiality* – your local authority is not obligated to disclose examples for every different category of property – try to focus on the larger categories only (especially if the differences in rating treatment are minor). Look for the major sources of difference in rating treatment and base your selection on those (often these will correspond to the categories used for differential rating purposes). This principle is especially relevant for those local authorities with more complex rating systems (ward/community based rating, classification based rating of river schemes etc).

Some local authorities include material in LTPs that is designed to help ratepayers "calculate an indicative rating level" on their property. The requirement to show samples, while similar, is not intended to cover every property in the district. For that reason, those that publish a "calculate your rates" section in LTPs and Annual Plans should consider continuing with this.

Group Level FIS

Each of your groups of activity must have its own FIS. Group level FIS must:

- separately show general rate income allocated to fund the group, and must include in targeted rate income an allocation of any targeted rate that contributes to funding more than one group of activities
- show separately the amount of income from general sources (for example dividends) allocated to the group
- include internal transactions such as the allocation of corporate overhead expenses, internal borrowing and reserve fund movements.

You may need to adjust budgeting and reporting procedures to show the first two allocations. As discussed in section 6.5 all reserve funds must be separately disclosed. Where reserve funds relate to an individual group of activities, it may be useful to disclose those reserves with FIS for a group of activities.

It may also be helpful to include your note disclosure of depreciation expense for a group of activities alongside your group level FIS, possibly compared to the proposed capital expenditure disclosed in the FIS.

FRS 42 (paragraph 40) requires that where an entity presents prospective financial information over and above what is in the prospective financial statements (required by GAAP) then the relationship between the two must be explained. This can be done either by reconciliation or narrative.

The group level FIS does not need to include all of the disclosures of the mechanics of rates, fees and charges etc that go in the council level FIS – it is purely a financial statement.

The prescribed format for the financial component of the group level FIS is specified in financial disclosure regulations. Appendix 6.2 shows the format for a group of activity FIS.

The group-level FIS is intended to replace the so-called 'cost of service' statements that local authorities were accustomed to produce. However, we recommend that local authorities consider whether a cost of service statement is a practical necessity as:

- the group level FIS is focussed on inputs
- there may be no other disclosure of the total cost of an activity within a group of activities
- the FIS does not include all revenues and costs (especially depreciation)
- the FIS is not GAAP compliant.

If you are considering retaining a cost of service statement as additional information then it should address the following:
- the estimated expenses and how the expenses will be met
- the estimated revenue levels, and other sources of funds.

Each cost of service statement should:
- be prepared at group of activities level
- be prepared in accordance with GAAP
- reflect separately, both the operating and capital expenses associated with the group and the funding of both operating and capital expenses for the group
- should explain any differences between revenue or funding levels and the Revenue and Financing Policy
- should state what is happening to any operating surpluses
- identify any reserve(s) that are used to fund operating deficits and explain any departure from the Revenue and Financing Policy
- should reconcile to the Statement of comprehensive income, both individually, where appropriate, and in total.

The Annual Plan FIS

Annual Plans must contain FIS at whole of council level. The prescribed format for each is shown in Appendix 6.3 and 6.4.

The Annual Report FIS

Annual reports must now also contain FIS at both council and at groups of activity levels. These FIS must also comply with the financial disclosure regulations. Like other financial information in the annual report, the FIS must be audited.

The formats for these FIS are shown in Appendices 6.4 and 6.5.

6.5 Additional Disclosures

Reserves

This is a requirement of the LTP, annual plan and annual report. Each reserve fund must be separately identified and the purpose of the fund and the activities it relates to have to be documented. A reconciliation from the opening balance to the closing balance (at the completion of the ten year life of the LTP), together with movements in and out of the reserve, is required. Note that the definition of reserve funds in the Act is potentially a very wide one – "money set aside by a local authority for a specific purpose" – but the reference to money set aside means that items such as asset revaluation reserves are excluded.

This disclosure requirement appears to have come out of two things:

- concerns that reserve funds are reaching significant levels across the sector
- concerns expressed by ratepayers that the purpose of some reserves, and application of funds is not as transparent at it could be.

Those local authorities that have significant numbers of reserves should not underestimate this requirement.

As part of the LTP preparation process it may be useful to review the reserves you have and formalise with your council whether they will continue or should be rationalised. It may also be helpful to review your procedures for recording transactions relating to reserves so you can be confident that when your annual report is audited that there are no problems with providing the supporting information needed to satisfy auditors of the accuracy of your reporting.

Internal Borrowing

From 2012 local authorities must disclose all internal borrowing in annual reports. Internal borrowing is defined as the incurring of debt by the use for any purpose, of funds received for another purpose, if the council has decided to repay the funds (whether or not interest is charged). The following must be disclosed for each group of activities:

- the amount of internal borrowing
- the level of borrowing and debt repayment during the year
- the level of interest, if any, charged during the year.

Capital Expenditure

Capital expenditure for each group of activities must be disclosed by expenditure to meet the additional demand for an activity, expenditure to improve the level of service and expenditure to replace existing assets.

Things to Remember: Financial Statements

1. Financial statements are the other half of the right debate as well as being a key input into decision-making in their own right.

2. Financial information should integrate with the remainder of the LTP but should also be clear, transparent, robust, and balance level of detail and usefulness to the reader.

3. The funding impact statement is exempt from the requirements of GAAP but must follow the formats prescribed in the Financial Disclosure regulations. These statements are meant to show only flows of funding and therefore exclude vested assets, revaluations and depreciation.

4. Your council-level FIS is one of the procedural requirements of the rate-setting process and sets out all of the mechanics of the rating system and some examples of the impact of the rating proposals. Defects in your FIS can invalidate any action taken in reliance on the FIS.

5. Changes made to the Act during 2010 have added disclosures around reserve funds, and internal borrowing and clarified expected disclosures for capital expenditure. Note that the LTP must separate capital expenditure into that which is growth related, that which is to promote level of service improvements and renewals.

FURTHER READING AND RESOURCES

Audit New Zealand, *Te Motu District Council - Model Financial Statements* – a model set of financial statements that complies with the requirements of the International Financial Reporting Standards. Note that at the time of writing (August 2011) this does not include a FIS or any of the other of the other elements of the *Financial Disclosure Regulations 2011*.

Generally Accepted Accounting Practice

APPENDIX 6.1: FUNDING IMPACT STATEMENT FOR LONG-TERM PLAN (WHOLE OF COUNCIL)

[*Name of Council*]: Funding Impact Statement for [*period*] (*whole of council*)

	*Year -1	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
	Annual Plan										
	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)
Sources of operating funding											
General rates, uniform annual general charges, rates penalties											
Targeted rates (other than a targeted rate for water supply)											
Subsidies and grants for operating purposes											
Fees charges and targeted rates for water supply											
Interest and dividends from investments											
Local authorities fuel tax, fines, infringement fees, and other receipts											
Total operating funding (A)											
Applications of operating funding											
Payments to staff and suppliers											
Finance costs											
Other operating funding applications											
Total applications of operating funding (B)											
Surplus (deficit) of operating funding (A - B)											
Sources of capital funding											
Subsidies and grants for capital expenditure											
Development and financial contributions											
Increase (decrease) in debt											
Gross proceeds from sale of assets											
Lump sum contributions											
Total sources of capital funding (C)											

	*Year -1	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
	Annual Plan										
	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)
Application of capital funding											
Capital expenditure											
- to meet additional demand											
- to improve the level of service											
- to replace existing assets											
Increase (decrease) in reserves											
Increase (decrease) of investments											
Total application of capital funding (D)											
Surplus (deficit) of capital funding (C - D)											
Funding balance ((A-B) + (C-D))											
* Specify the actual years of the long-term plan. The actual year for (year -1) is the year before the first year of the long-term plan.											
Other information to be included in accordance with *clause 15* of *Schedule 10* of the *Local Government Act 2002*											
[Include the information specified in *clause 15(3)* to *(5)* of *Schedule 10* of the *Local Government Act 2002* where relevant]											

APPENDIX 6.2: FUNDING IMPACT STATEMENT FOR LONG-TERM PLAN (GROUP OF ACTIVITIES)

[*Name of Council*]: Funding Impact Statement for [*period*] (*group of activities*)

	*Year -1	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
	Annual Plan										
	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)
Sources of operating funding											
General rates, uniform annual general charges, rates penalties											
Targeted rates (other than a targeted rate for water supply)											
Subsidies and grants for operating purposes											
Fees charges and targeted rates for water supply											
Internal charges and overheads recovered											
Local authorities fuel tax, fines, infringement fees, and other receipts											
Total operating funding (A)											
Applications of operating funding											
Payments to staff and suppliers											
Finance costs											
Internal charges and overheads applied											
Other operating funding applications											
Total applications of operating funding (B)											
Surplus (deficit) of operating funding (A - B)											
Sources of capital funding											
Subsidies and grants for capital expenditure											
Development and financial contributions											
Increase (decrease) in debt											
Gross proceeds from the sale of assets											
Lump sum contributions											
Total sources of capital funding (C)											

	*Year -1	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
	Annual Plan										
	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)	($000)
Application of capital funding											
Capital expenditure											
- to meet additional demand											
- to improve the level of service											
- to replace existing assets											
Increase (decrease) in reserves											
Increase (decrease) of investments											
Total application of capital funding (D)											
Surplus (deficit) of capital funding (C - D)											
Funding balance ((A-B) + (C-D))											
* Specify the actual years of the long-term plan. The actual year for (year -1) is the year before the first year of the long-term plan.											

APPENDIX 6.3: FUNDING IMPACT STATEMENT FOR ANNUAL PLAN (WHOLE OF COUNCIL)

[*Name of Council*]: Funding Impact Statement for [*period*] (*whole of council*)

	*Year -1	Year 1	Year 1
	Annual Plan	Long-term Plan	Annual Plan
	($000)	($000)	($000)
Sources of operating funding			
General rates, uniform annual general charges, rates penalties			
Targeted rates (other than a targeted rate for water supply)			
Subsidies and grants for operating purposes			
Fees charges and targeted rates for water supply			
Interest and dividends from investments			
Local authorities fuel tax, fines, infringement fees, and other receipts			
Total operating funding (A)			
Applications of operating funding			
Payments to staff and suppliers			
Finance costs			
Other operating funding applications			
Total applications of operating funding (B)			
Surplus (deficit) of operating funding (A - B)			
Sources of capital funding			
Subsidies and grants for capital expenditure			
Development and financial contributions			
Increase (decrease) in debt			
Gross proceeds from the sale of assets			
Lump sum contributions			
Total sources of capital funding (C)			

	*Year -1	Year 1	Year 1
	Annual Plan	Long-term Plan	Annual Plan
	($000)	($000)	($000)
Application of capital funding			
Capital expenditure			
- to meet additional demand			
- to improve the level of service			
- to replace existing assets			
Increase (decrease) in reserves			
Increase (decrease) of investments			
Total application of capital funding (D)			
Surplus (deficit) of capital funding (C - D)			
Funding balance ((A-B) + (C-D))			
* Specify the actual year of the annual plan and the same year for the long-term plan. The actual year for [year -1] is the year before the year of the annual plan			
Other information to be included in accordance with *clause 20* of *Schedule 10* of the *Local Government Act 2002*			
[Include the information specified in *clause 20(3)* to *(5)* of *Schedule 10* of the *Local Government Act 2002* where relevant]			

APPENDIX 6.4: FUNDING IMPACT STATEMENT FOR ANNUAL REPORT (WHOLE OF COUNCIL)

[*Name of Council*]: Funding Impact Statement for [*period*] (*whole of council*)

	*Year -1 Annual Plan ($000)	*Year -1 Annual Report ($000)	Year 1 Long-term Plan ($000)	Year 1 Actual ($000)
Sources of operating funding				
General rates, uniform annual general charges, rates penalties				
Targeted rates (other than a targeted rate for water supply)				
Subsidies and grants for operating purposes				
Fees charges and targeted rates for water supply				
Interest and dividends from investments				
Local authorities fuel tax, fines, infringement fees, and other receipts				
Total operating funding (A)				
Applications of operating funding				
Payments to staff and suppliers				
Finance costs				
Other operating funding applications				
Total applications of operating funding (B)				
Surplus (deficit) of operating funding (A - B)				
Sources of capital funding				
Subsidies and grants for capital expenditure				
Development and financial contributions				
Increase (decrease) in debt				
Gross proceeds from the sale of assets				
Lump sum contributions				
Total sources of capital funding (C)				

	*Year -1	*Year -1	Year 1	Year 1
	Annual Plan	Annual Report	Long-term Plan	Actual
	($000)	($000)	($000)	($000)
Application of capital funding				
Capital expenditure				
- to meet additional demand				
- to improve the level of service				
- to replace existing assets				
Increase (decrease) in reserves				
Increase (decrease) of investments				
Total application of capital funding (D)				
Surplus (deficit) of capital funding (C - D)				
Funding balance ((A-B) + (C-D))				
*Specify the actual years.				
The actual year for (year -1), in both cases, is the year before the year of the annual plan.				
The actual year for (year 1), in both cases, is the year of the annual plan to which the annual report relates				

APPENDIX 6.5: FUNDING IMPACT STATEMENT FOR ANNUAL REPORT (GROUP OF ACTIVITIES)

[*Name of Council*]: Funding Impact Statement for [*period*] (*group of activities*)

	*Year -1	Year 1	Year 1
	Long-term Plan	Long-term Plan	Actual
	($000)	($000)	($000)
Sources of operating funding			
General rates, uniform annual general charges, rates penalties			
Targeted rates (other than a targeted rate for water supply)			
Subsidies and grants for operating purposes			
Fees charges and targeted rates for water supply			
Internal charges and overheads recovered			
Local authorities fuel tax, fines, infringement fees, and other receipts			
Total operating funding (A)			
Applications of operating funding			
Payments to staff and suppliers			
Finance costs			
Internal charges and overheads applied			
Other operating funding applications			
Total applications of operating funding (B)			
Surplus (deficit) of operating funding (A - B)			
Sources of capital funding			
Subsidies and grants for capital expenditure			
Development and financial contributions			
Increase (decrease) in debt			
Gross proceeds from the sale of assets			
Lump sum contributions			
Total sources of capital funding (C)			

	*Year -1	Year 1	Year 1
	Long-term Plan	Long-term Plan	Actual
	($000)	($000)	($000)
Application of capital funding			
Capital expenditure			
- to meet additional demand			
- to improve the level of service			
- to replace existing assets			
Increase (decrease) in reserves			
Increase (decrease) of investments			
Total application of capital funding (D)			
Surplus (deficit) of capital funding (C - D)			
Funding balance ((A-B) + (C-D))			
* Specify the actual years. The actual year for (year -1) is the year before the current year of the long-term plan.			
The actual year for (year 1), in both cases, is the year of the long-term plan to which the annual report relates			

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