373 AMQ International's STRATEGIC ASSET MANAGEMENT

August 19 2013

FINANCIAL SUSTAINABILITY

A city of 1.8 million in 1950, Detroit is now home to just 700,000 people. PHOTO: THE NEW YORK TIMES

On 18th July Detroit filed for bankruptcy. No one is quite sure what its debt levels are but estimates range between $18 billion US to $20 billion US. As far as I can tell that does not include the costs to repair the dilapidated infrastructure and in reports on the subject, failing infrastructure is just a throwaway line. Detroit is the latest and by far the biggest council to file for bankruptcy but there have been many others in recent years. In this atmosphere of heightened awareness, it is perhaps timely to look again at the Financial Sustainability of our councils.

It is important to say at the outset that councils in Australia, New Zealand and the UK, are structured very differently from those in the USA and we should not imagine that our councils will go bankrupt. They won't. However, they may struggle for finances and need to reduce service levels. Their success in securing funds and making the service level adjustments they need will depend on how the council financial sustainability story is understood by the community, the media, and by government itself - and we, as asset managers, have a major hand in shaping that story.

Enjoy! *Penny*

Dr Penny Burns, Editor, AMQ International
08 8359 0559 www.amqi.com

A 'Wake Up Call'?

In the Weekend Australian Financial Review (20-21 July) and again in the Times (August 8) where there was extensive coverage, both referred to the collapse of Detroit as a 'wake up call' -- *but who or what is being 'woken up'?*

Reliance on clichés like a 'wake up call' is a sure sign that no one has a clue what to do, or even what the problem really is, and this is certainly the case here for no one has suggested methods that could be taken to avoid other US councils going the same way. However perhaps we can learn from the Detroit experience to make things better here, **after all we have already done it once!**

The 1984/85 New York experience with its failing infrastructure was a genuine 'wake up call' for Australia and New Zealand in that we saw what was happening in New York and realised that the reasons for their dilemma also applied here. We, too, did not know what assets we had, what condition they were in, and we didn't have any plans for managing them better. However we took steps to change that situation. **Today we have a thriving asset management industry.**

Can we use the Detroit experience in the same way? To jog us into avoiding the worst aspects of collapse? We are in a much better position with knowledge of financial sustainability today than we were with asset management in the mid-80s, for in the last ten years there have been major studies, both at state and national level, on the financial sustainability of councils. **Can we now build on this to help our communities, media and government to understand the true picture and the real options facing us?**

JOHN HOWARD, IPWEA NAMS.AU Project Manager, in his recent, entertaining, address to the IPWEA Conference in Darwin, thinks we can, and here we consider some of his arguments.

Act 1: Tell 'em they're dreaming!

Act 1, Scene 1 - Daily News Backlog Infrastructure Backlog

$100 million backlog for Victorian Councils (reduced from $280 million in 2007-11)

$7.4 billion backlog for NSW Councils

Assuming these represent the range across Australia - then Australia has a $18.4 billion backlog

Headline - Canberra, We have a problem!

Act 1, Scene 2 - PM's Policy Unit, Canberra

Staffer 1:

The PM has a problem, Local Government wants $18.4 billion to fix a backlog, but our finances are tight

Staffer 2:

So WE have a problem - we need to come up with a solution that makes the PM look good - and we need to do it soon! Let's call in Treasury & Finance for expert advice.

Enter TFE (Treasury & Finance Expert) 1:

Look, it's clear that local government operating revenue is sufficient to cover operating expenses and produce a surplus to invest in new assets or repay debt. The 2010-2011 Government Financial Statistics shows a Net Operating Balance of $4.18B for Australian LG.

Also Enter TFE2:

Their investment in new assets is 60% greater than consumption - the GFS show that purchase of new non-financial assets was $9.2B, far higher than depreciation of assets at $5.7B.

TFE 1:

Local Governments shouldn't have a backlog. They made a surplus in 2010 and spent $9.2B on new non-financial assets.

TFE 2:

They have two clear options - one, invest the surplus in the backlog - gone in 5 years; or two - target current capital expenditure to backlog - gone in 2 years!

Staffer 1:

Great, so we can advise the PM that Local Government can solve its backlog in 2 years by itself! They don't need our help.

Staffer 2:

'Tell 'em they're dreaming!'

Act 2: Backlog, the school visit

Act 2, Scene 1: Minister for Backlog on School Visit

Student: What is a backlog?

Minister: Things we should have done to make things better

Student: How big is the backlog?

Minister: $18.6 billion for all Australian councils

Student: How do you measure the backlog?

Minister: It is the cost to do things that we think need doing

Student: Why is the backlog so big?

Minister: There are a lot of things that need doing.

Student: If these things need doing, why haven't you done them by now?

Minister: We are doing other things that are more important

Student: Won't there always be more things that you want to do, no matter how much you do now?

Minister: Well, yes.

Student: So you will always have a backlog?

Meanwhile, Backstage in the PM' s Policy Unit

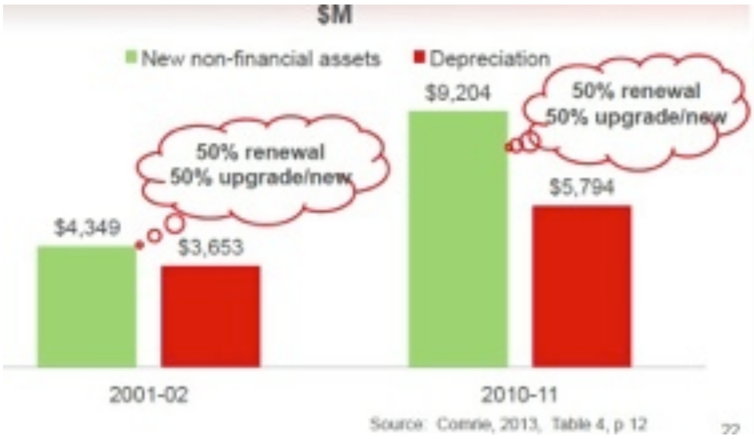
The Treasury Genius Group are anxious to ensure that the PM is not embarrassed by mistakes in the figures, they check the finances and the backlog figures, and seek to give more positive advice than 'Tell 'em they're dreaming!'. They note the following in the Government Financial Statistics for 2010-2011. There it is, in black and white - a Net Operating Balance of $4,180.

GFS Revenue	$M	GFS Expenses	$M
Taxation revenue	12,408	Gross operating expenses	
Current grants & subsidies	3,376	Depreciation	5,794
Sales of goods & services	8,466	Employment expenses	10,891
Interest income	1,192	Other operating expenses	11,447
Other	8,060	GFS other	1,192
Total	33,503	Total	29,323
		GFS Net Operating Balance	4,180

What they don't notice is the category called "Other", sitting there at a whopping $8.06 billion. Approximately 75% of this is "Capital Revenue", amounts received especially for new or upgraded assets. Capital Revenue is approx. $6.045 billion (developer contributions and other capital tied amounts).

When this is taken into account, the Net Operating Balance of $4.18 billion become a Net Operating DEFICIT of $1.865 billion.

The Treasury Genius Group also carefully check Local Government Expenditure and Depreciation for 2010-2011 and note that expenditure on new non-financial assets for that year is $9.204 billion - a very healthy excess over depreciation of $5.794 billion.



Again, what they don't notice - because no distinction is made in the Government Financial Statistics - is that only about 50% of this amount is renewal, the other 50% are new and upgraded assets added to the portfolio.

When this is taken into account, as it is in the Asset Sustainability Ratio, then we see the true picture - capital renewal is less than depreciation (although the picture has improved since 2001-2002)

However, because they do not have figures from the Asset Sustainability Ratio, the Treasury Genius Group do not know that asset sustainability is 79%, not the 159% they are thinking about.

The Treasury Genius Group now turn their attention to Depreciation. This is a significant proportion of expenses at 20%. How accurate is it?

> Here they have to confess that they do not know. This makes them nervous and unwilling to put too much stock in arguments involving depreciation or asset consumption.

They note that the Queensland Auditor General has voiced considerable concerns in his recent audits - "Most issues identified... arise from lack of evidence to support the completeness and accuracy of underlying asset component data and to support the key inputs and assumptions used to calculate the DRC (depreciated replacement cost)" They note that improving the reliability and consistency of valuations used to determine depreciation will result in a greater accuracy and reliability of depreciation as a measure of asset consumption .

[The Australian Infrastructure Financial Management Guidelines provides best practice guidance]

Over to you in the audience

THE ACCOUNTANT

Our major concerns are

1. The inclusion of capital revenue in the operating result turns a $1.85 Billion Net Operating Deficit into a $4.81B GFS surplus.

2. Using the total capital expenditure as the correct figure for the sustainability ratio, which has the effect of artificially increasing an actual sustainability ratio of 79% to 159%

3. With the accuracy and reliability of depreciation (e.g. the Queensland Audit Office findings)

THE ENGINEER

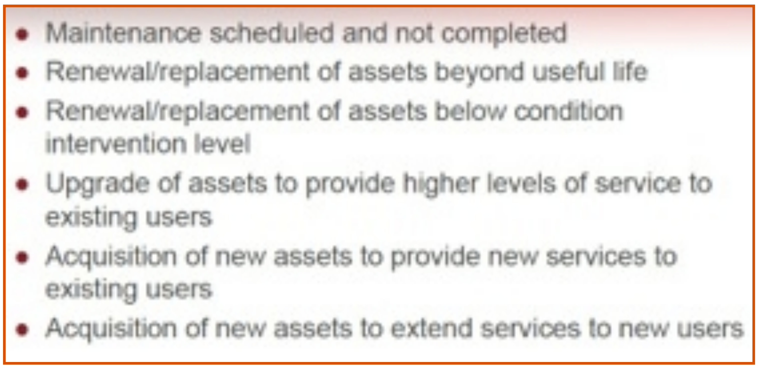
Our major concerns are with the backlog. We are not really consistent about what we put in our backlog.

Backlog can include: ---->

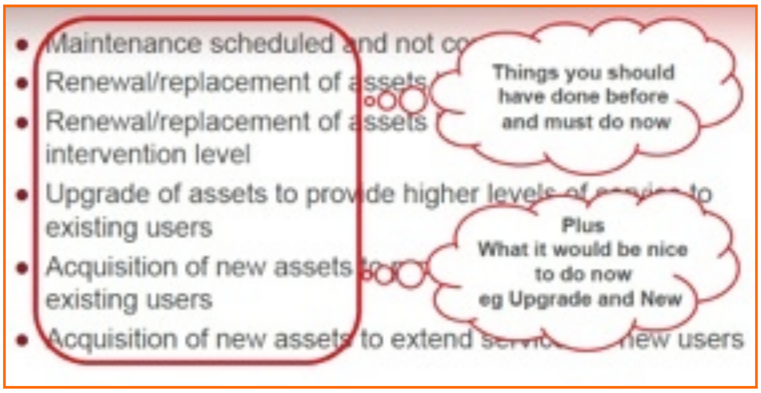
In Victoria, backlog is the value of asses with a condition rating less than desired intervention level.

In NSW, backlog is the funding required to bring assets to a 'satisfactory standard'

but who determines 'desired' or 'satisfactory standard'?



This leaves a lot of scope for personal judgement so that it is not difficult to see why others refer to them as 'engineers' wish lists'



Back to the play: the Treasury Genius Group Findings

The Treasury Genius Group decide that
Financial Sustainability must be the objective

Local Governments have the tools

AM Plans
Long-Term Financial Plans
Community Engagement

They need to give decision makers accurate and realistic information on which to make better decisions and to understand the consequences.

The Treasury Genius Group say that

ENGINEERS CAN

Ensure service levels in AM Plans are realistic and affordable

Communicate the agreed and financed service levels with service and risk consequences in budget decisions

Work with accountants to improve accuracy and reliability of depreciation estimates

ACCOUNTANTS CAN

Ensure the Operating Result (net of capital revenues) is reported in organisational reports and publicity

Report the Operating Surplus Ratio, Asset Sustainability Ratio/ Asset Renewal Funding Ratio and Capital Renewal Expenditure in financial statement notes

Work with engineers to develop AM Plans, LTFPs and strategies that provide for community needs and are financially sustainable.

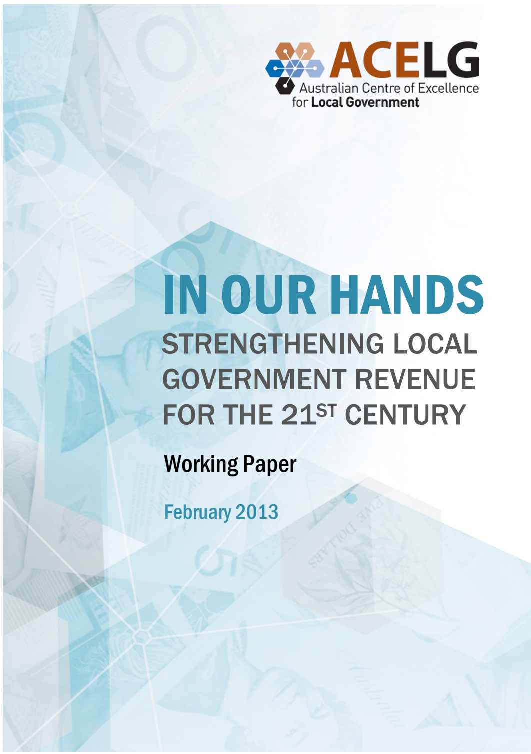
A Financial Sustainability objective can deliver results.

South Australian local governments

In 2001 - needed to spend 3 times as much on asset renewal

Increased renewal expenditure by 3.5 times over the last ten years

Improved financial performance from $100 million deficit in 1999-2000 to an operating breakeven position in 2010-2011.



Time out now for a word from John Comrie.

John is a former council Chief Executive Officer and Executive Director of the Local Government Association of South Australia (LGASA) and the South Australian Government's Office for State/ Local Government Relations.   In February he produced *"In our hands: strengthening local government revenue for the 21st Century"* for the Australian Centre of Excellence for Local Government (ACELG), which is available online. It is an easy to read and carefully measured statement of the current financial position of Australian local government and what needs to happen next.

Councils are facing the need to replace or renew ageing assets and they do not have the funds that they would like to be able to do the job at the level they would like.

How serious is this?

JC:There is wide variation in the financial performance and capacity of Australian local governments. Most are in at least a satisfactory financial position or have the capacity to be so over the medium-term through reasonable and responsible financial decision-making. Some others, often with large geographic areas and small population bases, need additional financial support. (p.4)

Is help likely to be available from the Federal Government?

JC: A case exists for greater levels of financial support for the sector from other spheres of government. Such an outcome is unlikely to be materially realised in the near-to medium-term given the other priorities and projected financial outlooks of the Commonwealth and most states and the Northern Territory.

As a result, improved future financial performance will, for most councils, depend to a large degree on their own decision-making. This will involve a variety of factors but improving financial understanding and expertise at both officer and elected levels, and better long-term planning, are key.

For example, councils often have more capacity than they appreciate to address perceived asset renewal needs and increased service level preferences. (p.4)

Surely the States and Commonwealth could do more for local government?

JC: Regardless of the justification, it may be hard for the sector to secure material net additional financial support. The Commonwealth and states are faced with growing annual expenditure obligations and demands driven by demographic trends, rising health care costs, and proposed additional welfare and education - related expenditure programs. The annual rate of increase in costs for their existing policy obligations is likely to be far higher than that of local governments. At the same time, their increase in taxation growth in recent years and current forward projections are less than previously forecast (p.23)

JC: It needs to be borne in mind that taxation revenues collected by the Commonwealth and the states are far more volatile than those of local governments. The former are influenced to a large degree by changes in the level of economic activity. This is true even for states' revenue from property taxes, the majority of which is associated with stamp duty on property transactions. (p.18)

JC: If the local government sector wishes to successfully argue for additional grants from other spheres of government it should also be prepared to strongly advocate for increases in existing taxes and/or for additional taxes to be raised by these other spheres of government, or else nominate areas for expenditure reduction. There is no 'magic pudding'. Other spheres of governments' forward projections show little capacity for additional expenditure without additional revenue or reductions in expenditure elsewhere. (p.24)

Are Local Governments able to solve the problem themselves?

JC: Generally speaking, If a local government can achieve a small operating surplus on average over time it should be able to maintain service levels in the future, including renewing and replacing assets as required. The desirability of basing revenue and service level decisions on achieving a small ongoing underlying operating surplus is now widely accepted within the local government sector (but not yet universally), and by agencies responsible for regulating local governments in all jurisdictions. (p.27)

JC: The various inquiries confirmed that in all jurisdictions there were significant opportunities for improvement in local government financial management and performance. The reports suggested that many local governments did indeed have financial sustainability challenges. Typically in all jurisdictions it was suggested that 25% or more of local governments were 'financially unsustainable' under existing policy settings. These local governments were overwhelmingly ones with small populations (low own-source revenue base) and typically in rural localities and with large geographic areas to serve (higher costs per capita). (p.19)

JC: Local governments' share of total taxation revenue has remained modest throughout this period [at approx. 3 +/- .5 %] and had been declining further until recently. The turnaround is primarily a reflection of the relative decline in revenue of other spheres of government as a result of a slowdown in economic activity post the Global Financial Crisis (GFC). (p.17)

JC: Local governments' share of total taxation revenue has in fact been declining steadily on a trend line basis since at least the 1960s (Access Economics 2004) (p.18)

What can you tell us about Asset Renewal Backlogs?

JC: A wide range of studies have suggested that many local governments have significant asset renewal backlogs. Asset renewal backlogs arise where service levels from aged assets are less than is required or preferred and the responsible authority doesn't believe it has the financial capacity to renew such assets. The financial information listed in the [Government Financial Statistics] does not disclose or have regard to such backlogs. (p.13)