ENCL: YES	**ORDINARY COUNCIL MEETING/CONF**	**AGENDA ITEM:**	**C27.1.2**

FINANCIAL SUSTAINABILITY REVIEW

REPORT No.: 18CP0002 RI:je	**COMMON No.: 3554016**	**DATE: 30/01/2018**

Presenter: **Acting General Manager City Performance, Richard Iap**

Approved: **Chief Executive Officer, Brendan Dowd**

PURPOSE

The purpose of this report is to provide Elected Members with the final findings of Council's Financial Sustainability Review. This review has been undertaken by Deloitte Access Economics.

LINK TO STRATEGIC PLAN

The issues addressed in this Report are in accordance with the following Goals/Strategies as outlined in the 'Evolving Darwin Towards 2020 Strategic Plan':-

Goal
5 Effective and Responsible Governance
Outcome
5.5 Responsible financial and asset management
Key Strategies
5.5.1 Manage Council's business based on a sustainable financial and asset management strategy

KEY ISSUES

- Deloitte Access Economics has undertaken a financial sustainability review **(Attachment A)** of the City of Darwin's financial position and projections.
- This Financial Sustainability Review was presented to Council at a Special Council Workshop on 18 November 2017 by John Comrie from Deloitte Access Economics.
- The assessment has been based primarily on the content of Council's current (2016 to 2026) Long Term Financial Plan (LTFP).
- Council is currently in a reasonable financial position and not under any immediate financial constraint but ongoing financial sustainability challenges could possibly emerge in the future.
- The findings of this review will need to be taken into account during the upcoming review of the LTFP and in developing the 2018/19 Budget.

RECOMMENDATIONS

A. THAT Report Number 18CP0002 RI:je entitled Financial Sustainability Review, be received and noted.

B. THAT recommendations from the Financial Sustainability Review be presented for consideration at the March 2018 Risk Management and Audit Committee.

BACKGROUND

Local governments deliver essential services to communities with varying needs and expectations. These services are often infrastructure related. Many factors, including population scale and density, geographic location, industry structure and socio-economic advantage, shape the circumstances within which local governments operate. In terms of financial sustainability, the challenge for local governments is to balance growth in revenue and costs with service levels consistent with community preferences.

City of Darwin defines a sustainable financial strategy *as one which allows for the adequate provision for its programs (including capital expenditure) and services into the future with the intention that there is a predictable trend in the overall rate burden*. The aim of Council's financial strategy is to allow for an equitable distribution of the costs of establishing and maintaining council assets and services between current and future ratepayers.

DISCUSSION

Deloitte Access Economics has undertaken a financial sustainability review **(Attachment A)** of the City of Darwin’s financial position and projections. The assessment has been based primarily on the content of Council’s current (2016 to 2026) LTFP and various discussions with officers.

The financial sustainability review places particular emphasis on Council’s underlying projected result (operating revenue less operating expenses) in assessing financial sustainability.

Council is currently in a reasonable financial position and not under any immediate financial constraint but ongoing financial sustainability challenges could possibly emerge in future. It has significant cash holdings (both in reserves and unrestricted) and current forecasts are that it will be able to accommodate all expenditure forecasts over the ten-year planning period. It is however projecting small ongoing operating deficits over the planning period. There are a number of factors (such as the street lighting responsibilities and the revision to forecast future depreciation expenses) that may possibly add to these annual deficits without a change in financial strategy. It is important to remember that large current cash holdings are not a good indicator of long-run financial sustainability. Ongoing operating deficits indicate that over the long-term a council will need more resources than it has available to maintain service levels (for example to replace long-lived assets).

CONSULTATION PROCESS

In preparing this report, the following City of Darwin officers were consulted:

- Chief Executive Officer
- Manager Finance

In preparing this report, the following External Parties were consulted:

- John Comrie, Deloitte Access Economics

POLICY IMPLICATIONS

There will be a requirement to review particular Council policies in regards to the recommendations from the financial sustainability review.

These policies will include but are not limited to:

- Policy No. 023 - Borrowing Policy
- Policy No. 024 - Investment Policy
- Policy No. 067 - Financial Reserves Policy

Council may also consider development of a treasury management policy which refers to the way in which borrowings are raised and cash and investments are managed.

BUDGET AND RESOURCE IMPLICATIONS

Council is to consider the recommendations from the financial sustainability review as part of the adoption of the Long Term Financial Plan and Municipal Plan 2018/19.

RISK/LEGAL/LEGISLATIVE IMPLICATIONS

This item is considered 'Confidential' pursuant to Section 65(2) of the Local Government Act and 8(c)(iv) of the Local Government Administration Regulations, whereby the public may be excluded while business of a kind classified as information that would, if publicly disclosed, be likely to prejudice the interests of the council or some other person is discussed.

ENVIRONMENTAL IMPLICATIONS

Nil

COUNCIL OFFICER CONFLICT OF INTEREST DECLARATION

We the Author and Approving Officers declare that we do not have a Conflict of Interest in relation to this matter.

RICHARD IAP
ACTING GENERAL MANAGER
CITY PERFORMANCE

BRENDAN DOWD
CHIEF EXECUTIVE OFFICER

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Attachments:

Attachment A: Deloitte Access Economics Financial Sustainability Review Report

ATTACHMENT A

Deloitte.
Access Economics

Financial sustainability review

City of Darwin

Nov 2017

Contents

Executive summary iii

1 Introduction 5

2 Overview 6

3 Methodology applied 9

4 Broad assessment of Council’s ongoing financial sustainability 11

5 Assessment of asset management 15

6 Assessment of borrowing needs and capacity 17

7 Rating levels 19

8 Review of selected Council policies 21

9 Review of financial governance 23

10 Conclusions 25

11 Recommendations 26

Appendix A : Local government financial sustainability factors and guidelines 27

A.1. Distinguishing characteristics of local governments 27
A.2. Assessing local government financial performance and outlook 27
A.2.1. Underlying Operating Result 28
A.2.2. Service levels 29
A.2.3. Extent of Use of Debt 29
A.2.4. Asset management 30
A.3. Concluding comments 31

Appendix B : Review of financial indicators used by the City of Darwin 32

B.1. % of Rate Debtors Outstanding 32
B.2. Debt Servicing Ratio 32
B.3. Liquidity 33
B.4. Rates Ratio 33
B.5. Operating Surplus / (-Deficit) 33
B.6. Operating Surplus Before Depreciation 34
B.7. Asset Sustainability Ratio 34

Limitation of our work 35

General use restriction 35

Executive summary

Deloitte Access Economics has undertaken a financial sustainability review of the City of Darwin’s (Council’s or CoD’s) financial position and projections. The assessment has been based primarily on the content of Council’s current (2016 to 2026) long-term financial plan and various discussions with staff.

Council defines a sustainable financial strategy as one which allows for the adequate provision for its programs (including capital expenditure) and services into the future with the intention that there is a predictable trend in the overall rate burden. The aim of Council's financial strategy is to allow for an equitable distribution of the costs of establishing and maintaining council assets and services between current and future ratepayers.

Our analysis places particular emphasis on a council’s underlying projected operating result (operating revenue less operating expenses) in assessing financial sustainability. Generally, to maintain financial sustainability we encourage councils to strive for a small ongoing underlying operating surplus (generally say up to 5% of total operating revenue). Such a result would ensure that current ratepayers and service recipients are meeting the annualised cost of service provision and thus be intergenerationally equitable over time. It would also mean that a council would be well placed to have the resource capacity to accommodate asset renewal and unforeseen needs as and when required.

Local government service provision is very asset intensive and depreciation of assets represents a large share of total operating expenses (in the City of Darwin’s case it represents about 22% and this is broadly consistent with the typical circumstances of urban councils elsewhere). Local government assets are often long-lived but nevertheless do have finite useful lives. It is critically important that councils manage their assets to ensure service requirements are maintained, annualised whole of life costs are minimised and assets are able to be renewed and replaced when required.

Council is currently in a reasonable financial position and not under any immediate financial constraint but ongoing financial sustainability challenges could possibly emerge in future. It has significant cash holdings (both in reserves and unrestricted) and current forecasts are that it will be able to accommodate all expenditure forecasts over the ten-year planning period. It is however projecting small ongoing operating deficits over the planning period. There are a number of factors (such as the decision to assume street lighting responsibilities and possible revision to forecast future depreciation expenses) that may possibly add to these annual deficits without a change in financial strategy. It is important to remember that large current cash holdings are not a good indicator of long-run financial sustainability. Ongoing operating deficits indicate that over the long-term a council will need more resources than it has available to maintain service levels (for example to replace long-lived assets).

It appears likely that Council will need to take steps in order to achieve a satisfactory underlying ongoing operating result in future years. Such steps could take place gradually over time and broadly include:

1. Increasing operating revenue (particularly for example rate revenue which is the largest controllable source of revenue available to Council – average rates payable do not seem excessive relative to comparable local governments outside of the Northern Territory)
2. Improving ongoing efficiency
3. Reducing service levels (which would reduce operating expenses over time and could include delaying acquisition of new capital works).

An initial priority would be to update Council's long-term financial plan having regard to latest available information and the content of this report. This would provide a clear up-to-date basis of the extent of any future financial challenges.

Council has been progressing the development of the preparation of asset management plans. Given the high costs associated with the ongoing provision and maintenance of assets it is important that such plans be finalised in the near future (and regularly reviewed on an ongoing basis). It is also important that asset management plan expenditure projections be accommodated in Council's long-term financial plan. The latter plan should be updated at least annually.

It is important that CoD's management and elected body focus on longer-run financial projections when considering strategic priorities and in annual revenue-raising and expenditure decisions. A review of the financial indicators that Council reports projected performance against and targeted results aspired to be achieved is appropriate. Council's long-term financial plan should be based on strategies that enable achievement of target results consistent with financial sustainability. Similarly, annual budget decisions should be made consistent with the achievement of appropriate financial targets. It is important that long-run financial sustainability be a focus of Council in all strategic decision-making.

The issues and opportunities identified through this report where possible improvements may be desirable are consistent with those commonly found with other councils. Our experience elsewhere is that such improvements can normally be satisfactorily incrementally addressed with appropriate strategic commitment. Councils (particularly urban councils) previously in similar circumstances to those of CoD currently have been able to make relatively modest ongoing refinements over several years and in doing so secure their long-term financial sustainability.

Deloitte Access Economics

1 Introduction

Local governments deliver essential services to communities with varying needs and expectations. These services are often infrastructure related. Many factors, including population scale and density, geographic location, industry structure and socio-economic advantage, shape the circumstances within which local governments operate. In terms of financial sustainability, the challenge for local governments is to balance growth in revenue and costs with service levels consistent with community preferences.

Financial sustainability has been a key priority for local governments across Australia for over a decade. Deloitte Access Economics (then Access Economics) undertook local government sector level reviews of financial sustainability in most Australian states at the commencement of the rise in the focus on this issue. The results and findings of that work often lead to legislative reforms and culminated in councils placing more emphasis on longer-term financial and asset management planning.

Deloitte Access Economics has undertaken extensive follow-up local government financial sustainability- related work in the period since then including assessments and provision of advice to state agencies responsible for local government matters, local government associations and individual councils. In 2009 it undertook a financial sustainability review for the City of Darwin (CoD).

2 Overview

A breakdown of the City of Darwin's operating income budgeted for 2016/17 is shown below in Table 2.1:[1]

Table 2.1: City of Darwin, Operating Income 2016/17

Operating income	$('000)	Percentage
Rates & Annual Charges	67,235	63.1
User Charges	23,976	22.6
Interest & Investments	2,656	2.5
Operating Grants	5,355	5.1
Capital Grants	5,564	5.2
Other	1,634	1.5
Total	**106,420**	**100.0**

Source: City of Darwin

The broad breakdown of the City of Darwin's budgeted operating expenses for 2016/17 is shown below in Table 2.2:[2]

Table 2.2: City of Darwin, Operating Expenses 2016/17

Operating expenses	$('000)	Percentage
Employee Costs	31,727	30.9
Borrowings	229	0.2
Materials and Contracts	48,179	47.0
Depreciation	22,397	21.8
Total	**102,532**	**100.0**

Source: City of Darwin

Council's 2016-2026 long-term financial plan suggests that the breakdown of operating income and operating expenses will remain relatively consistent with that shown in the above tables over the 10-year planning period.

The share of operating costs apportioned by category can vary significantly between councils but there is nothing unusual about the CoD breakdown. Depreciation represents approximately 22% of Council's total operating expenditure in 2016/17. This is a large figure although it is broadly consistent with national averages. The level of recorded depreciation expenses can vary between councils depending on the scale of their infrastructure related services, e.g. the quality and extensiveness of their road networks and whether they have water supply and sewerage related services and the relativity of such services compared with others.

[1] Refer City of Darwin, Long-term financial plan, 2016 - 2026, p. 28.
[2] Refer City of Darwin, Long-term financial plan, 2016 – 2026 p.28.

Depreciation also represented 22% of operating expenses of South Australian local governments in aggregate in 2014/15.[3]

A comparison of Tables 2.1 and 2.2 indicates that CoD generated slightly more ($3,888,000) operating revenue than operating expenses. Deloitte Access Economics agrees with CoD's viewpoint that a more meaningful assessment of performance is achieved by not including capital revenue in such analyses. Capital revenue is essentially grants or other funds (or physical assets) provided to an entity. Any such monies must be utilised to construct additional physical assets. Receipt of capital revenues necessarily commits an organisation to additional long-run operating expenses typically at least equivalent to (and invariably in excess of) the capital revenue initially received.

It is important to note that CoD budgeted to generate $1,676,000 more in operating expenses in 2016/17 than it forecast to receive in operating revenue that year net of capital revenue.

Depreciation represents the consumption of assets in the provision of service (e.g. their value, usually on a replacement cost basis amortized over their expected useful lives, net of any applicable residual value). The high annual level of depreciation typically incurred by local governments reflects the very asset-intensive nature of local government. The value of CoD's assets and liabilities is shown below in Table 2.3:[4]

Table 2.3: City of Darwin, Assets and Liabilities, 30 June 2016

	$m
Assets	
Current (e.g. cash)	85
Non-current	
Infrastructure etc	1,106
Total Assets	**1,191**
Liabilities	
Payables, borrowings, provisions etc	**22**
Equity	**1,169**

Source: City of Darwin

Compared with annual Operating Income ($106 million in 2016/17) CoD has about 11.6 times as many assets. Local governments in Australia are generally far more asset-intensive in fulfilling their service- related responsibilities than the States or Commonwealth. That is, they have responsibility for management of depreciable assets with a much higher value relative to their annual income than the other spheres of government. The asset-intensive nature of local government activity means that there will be times when councils face the need for large capital outlays.

These assets that local governments control typically don't generate income and are very long-lived. They are predominantly infrastructure (mainly roads but also stormwater drains, footpaths etc) and some buildings.

[3] Refer SA Local Government Grants Commission Database Report 2014/15, Report 3, available at https://www.dpti.sa.gov.au/local_govt/LGGC
[4] Refer City of Darwin 2015/16 Annual Report, p.183.

Generally speaking, councils need to plan for and be able to maintain and renew and replace these assets as necessary in order to maintain service levels. Their capacity to do so is a critical consideration in the assessment of their ongoing financial sustainability.

Like most councils CoD has very low levels of borrowings and other liabilities. Borrowings are not income. They are a tool for managing timing mismatches between outlay needs and preferences and income. Given the asset-intensive nature of local government it is often appropriate for them to make considerable use of debt to assist in facilitating recovery of costs associated with provision of assets equitably over time through rates (and charges as appropriate).

The data above and particularly 10-year forecasts for this financial information is discussed in the following sections in assessing CoD's financial sustainability considerations.

3 Methodology applied

Local Government Financial Sustainability Inquiries were carried out by Deloitte Access Economics in most states around a decade ago. They were a catalyst for all Australian jurisdictions to develop requirements encouraging their local governments to focus more on their long-run financial sustainability in their strategic and budget planning and day to day expenditure decision-making. For example, all states have developed financial indicators that councils are required to report against. These financial indicators do vary somewhat across states but broad consensus is emerging.

The Northern Territory Government requires its municipalities to prepare long-term financial plans (as do all states now although Victoria is only currently introducing) but has not mandated the reporting of performance against any specified financial indicators. CoD measures financial performance against indicators it has selected as appropriate in its long-term financial plan (refer p.34).

In assessing the financial sustainability outlook for a council and determining an appropriate financial strategy, Deloitte Access Economics focuses primarily on assessing performance against just three financial indicators that relate to annual financial operating performance, the level of net debt and other liabilities, and asset management performance. It believes sound financial strategies can be set and satisfactory performance outcomes achieved by reliance on setting targets and monitoring results for this small number of indicators. It has also found that a focus on less rather than more indicators assists councils to identify key financial and asset management challenges and determine appropriate responses. These issues and the three indicators are briefly discussed below. (Further discussion regarding the rationale for our preferences and comments regarding financial indicators currently utilised by CoD is included in Appendices A & B.)

a) Operating Result Ratio (Operating revenue (excluding capital revenue) minus operating expenses expressed as a percentage of operating revenue).

If a council can maintain a positive underlying operating result over time (that is operating revenue in excess of operating expenses including depreciation), then sufficient revenue is being generated to offset the cost of service provision. It means that ratepayers and service recipients in any year are collectively ‘paying their way’ and that revenue generated from offsetting depreciation should help ensure that, on average over time, approximately sufficient net cash inflow is generated to substantially accommodate asset renewal outlay needs.

The prime objective of a council’s financial strategy should in most circumstances be to ensure that it achieves and maintains a small underlying operating surplus on an ongoing basis. If it can do that then it should be able to maintain service levels and address asset management needs as and when required.

It is critical that councils have regard to impacts on financial sustainability when determining service levels. Operating expenses are driven by service levels. Any assessment of a council's financial sustainability is predicated on the range and level of services provided. Acquisition of a new additional asset, or upgrading of an existing asset to provide higher levels of services, even if the capital expenditure is funded by a grant, will lead to higher subsequent operating costs for a council in the form of ongoing asset maintenance and depreciation.

Deloitte Access Economics also favours a focus on 'underlying' performance. That is the reported operating result adjusted for one-off or temporary factors such as the recent abnormal timing of ongoing Commonwealth Financial Assistance Grants.

b) Net Financial Liabilities Ratio (An entity's total liabilities less financial assets expressed as a percentage of operating income.)

Deloitte Access Economics prefers this measure of borrowing levels and capacity relative to others such as debt-servicing ratios in a local government context. Debt-servicing ratio scores are influenced by loan repayment terms and are not an indicator of debt levels. (A council may have a short repayment duration and relatively high repayments but nevertheless relatively low debt.)

c) Asset Sustainability Ratio (Asset renewal undertaken in a period relative to that recommended in an asset management plan (expressed as a percentage.)

Many councils calculate this ratio by expressing asset renewal undertaken in a period relative to depreciation (expressed as a percentage). Deloitte Access Economics prefers the practice required to be followed by South Australian local governments where the denominator for this ratio is not depreciation but asset renewal needs identified in an entity's asset management plan. (Such a ratio is also known as the asset renewal funding ratio in some instances). Our experience is that optimal asset renewal needs can fluctuate over time and are not necessarily consistent with annual depreciation, even over a multi-year period, particularly for entities with high value long-lived assets.

The above 3 financial indicator ratios are the same as recommended for financial sustainability assessment consideration by the Institute of Public Works Engineering Australasia (IPWEA) and required to be reported against by South Australian local governments.[5]

[5] See IPWEA, 2015, 2nd ed, 'Australian Infrastructure Financial Management Manual', Institute of Public Works Engineering Australasia, Sydney, www.ipwea.org/AIFMM and SA Local Government Association Financial Sustainability Information Paper no.9 – Financial Indicators available at http://www.lga.sa.gov.au/webdata/resources/files/LG_FS_Info_Paper_9_-_Financial_Indicators_-_2012.pdf

4 Broad assessment of Council's ongoing financial sustainability

As highlighted in Section 3 Deloitte Access Economics places particular emphasis on a council's underlying long-run projected operating result ratio in assessing ongoing financial sustainability. Assuming reliable data is available then in general circumstances we would expect a municipality to be financially sustainable if it can maintain a small (at least breakeven but possibly of the order of up to 5%) positive operating result ratio. If it can do this then it would indicate that ratepayers and other service recipients in aggregate are fully offsetting the total annual cost of the provision of services. It is also likely to mean in such circumstances that a council would be able to fund the renewal and replacement of assets when it is optimal to do so over time (even if additional borrowings are necessary in some periods of peak asset renewal outlays).

The forecast operating result ratio for CoD (net of capital revenues and sourced from its current long-term financial plan) is shown below in Table 4.1.

Table 4.1: City of Darwin forecast operating result

Year (30 Jun)	16/ 17	17/18	18/19	19/20	20/21	21/22	22/23	23/24	24/25	25/26
Operating result ratio (%)	-1.7	-1.9	-1.9	-1.8	-1.4	-1.4	-0.9	-1.2	-0.5	-0.2

Source: City of Darwin

Table 4.1 indicates that CoD would need to generate an additional increase in its revenue base of up to 1.9% by year 2 (2017/18) in order to at least break even in subsequent years based on the above forecasts. Alternatively, operating expenditure would need to be reduced by a similar amount (or some combination of both). This could for illustrative purposes be achieved by an increase in average annual rates of about 3% beyond what has already been assumed in Council's model (given that rates represented about 63% of total budgeted operating revenue in 2016/17 (see Table 2.1)).

An improvement in the long-run underlying operating result ratio to about 5% per annum would require additional increases in operating revenue or decreases in operating expenses. If the improvement came solely from rate revenue increases it would require further additional rate revenue increases of about 8%. That is an 8% increase in aggregate more than the 3% highlighted above and the 1.5% per annum real increase assumed in CoD's long-term financial plan. This increase would need to rise further if operating expenses rose beyond forecast projections.

Deloitte Access Economics' experience is that councils' often struggle to achieve the future underlying operating result ratio projected in their long-term financial plans. That is, ongoing revenue turns out to be somewhat less and/or annual operating expenditure somewhat more than originally forecast. This possibility supports the case for basing plans on achieving a better than 'breakeven' result over time.

An analysis of CoD's long-term financial plan has been undertaken to assess the reliability of the financial forecasts projected. CoD has adopted a very clear and comprehensive long-term financial plan that lists major assumptions upon which it is based. Some brief comments regarding the key assumptions and other related statements in the document appear below.

The long-term plan assumes:

- Consumer Price Index (CPI) of 1.5% per annum. CPI (and CoD's cost increases) may be slightly higher on average than assumed (estimated CPI) over the next 10 years, notwithstanding short-run fluctuations, given that the Reserve Bank's monetary policy is aimed at keeping CPI within the 2% to 3% band,
- Rate increases are assumed to be 3% per annum. That is a 3% average increase for existing ratepayers. Council's rate revenue is forecast to grow by this amount plus the impact of property development growth (total of about 4% per annum). This 3% average increase per property represents a real rate increase over and above the assumed inflation rate of about 1.5% per annum. Note what is more important than the assumed CPI and the nominal rate of increase (increase in prices inclusive of underlying inflation rate) in rates is the effective assumed real increase in rates (increase over and above inflation). The long-term financial plan effectively assumes a real increase in rates of about 1.5% per annum for existing ratepayers,
- Growth of 1.2% per annum (although not explicit in the document it is understood that rates and other income and expenses have been adjusted for this factor),
- No indexation of Commonwealth Financial Assistance Grants (indexation was restored in the recent Commonwealth budget and it is considered more likely than not that annual indexation will be maintained hereafter – applicable legislation effectively requires annual indexation except in special circumstances),
- A 3% per annum increase in employee costs,
- No significant nominal increase in asset values arising from revaluations over the period. The plan states that '*Land, Buildings and Infrastructure revaluations every three years in accordance with Council's revaluation policy are not expected to increase significantly in the current economic environment and have been omitted from this modelling'* (p.22).
- There may be a perception that assets may already be somewhat over-valued in aggregate (and hence depreciation over-stated). Council's 2015/16 financial statements suggest roads and other infrastructure was last revalued in June 2014 (and other assets more recently). Generally speaking, we would expect asset values (net of acquisition of new assets and net of annual depreciation) to increase at about the rate of CPI each year. As such we would expect annual depreciation to increase about in line with CPI. The acquisition of other additional assets would of course then add further to long-run depreciation costs.
- Depreciation is forecast in the Plan to increase by 16.7% over the nine years of the plan relative to the 2016/17 base year (average annual

increase of 1.7% per annum) The basis of this assumption is not clear. Presumably it is an estimate of the impact of inflation and growth.

- The plan assumes the identification and realisation of savings of $300,000 in 2017/18. It is unclear whether this will be able to be readily achieved and any associated implications.
- No allowance has been made in the Plan for the possible financial impact from the Council taking full responsibility for controlling provision of street lighting. It is Deloitte Access Economics' understanding that a recent report prepared for Council suggested that annual operating costs could increase by about $2.5-3.0 million (although still cheaper than forecast increases that would have otherwise occurred if Council maintained previous arrangements).[6] Such an increase in costs would adversely decrease CoD's reported Operating Result Ratio by about 2.5% – 3.0% per annum.
- Council has included a provision of $19.1M in its 2016/17 financial statements as an estimate of future landfill rehabilitation costs. No allowance for any related work was included in the long-term financial plan (but will be in the next update).

It is understood that further work is currently ongoing to refine the useful lives of CoD's assets and associated depreciation. Depreciation necessarily will always be an estimate but it is important given the asset intensive nature of local government that work be undertaken by all councils as warranted to ensure that this estimate is materially reliable on an ongoing basis.

The future is always uncertain but on balance it is our judgement based on the above that it is more likely that CoD's actual operating result ratio will be less favourable rather than more favourable over the next 10 years compared with existing long-term financial plan projections. Council will more likely than not need to modify its existing financial strategies and take specific pro-active steps to ensure its ongoing financial sustainability. Such steps could broadly include:

A Increasing operating revenue (particularly for example rate revenue which is the largest controllable source of revenue available to Council)
B Further improving ongoing efficiency
C Reducing service levels (which would reduce operating expenses over time and could include delaying acquisition of new capital works).

Our assessment is that Council is in a reasonable position and there is no indication at this stage of financial challenges arising in the short to medium term. For example, the statement of cash flows shown in Council's long-term financial plan indicates that based on projected revenue and expenditure forecasts it will generate sizeable total and unrestricted cash balances at year end each year over the planning period.[7] See table 4.2 below.

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[6] See p.42 of Next Energy's Darwin's Transition to City-Owned Public Lighting – Confidential Report of 4 May 2017.
[7] The unrestricted cash balance is net of cash holdings necessary from a legal or policy requirement to offset reserves established to accommodate future forecast obligations and preferences.

Table 4.2: City of Darwin forecast year end cash, cash equivalents and investments ($ millions)

Year (30 Jun)	16/ 17	17/18	18/19	19/20	20/21	21/22	22/23	23/24	24/25	25/26
Unrestricted ($M)	10.5	9.6	9.8	9.9	10.0	10.2	10.6	10.7	10.7	10.7
Total ($M)	46.3	48.7	48.0	49.2	54.9	50.6	28.8	37.0	43.2	54.2

Source: City of Darwin

It is critically important though that Council recognise that forecast significant ongoing cash holdings are not an indicator of ongoing financial sustainability. Large forecast cash holdings indicate that an entity is likely to be able to accommodate estimated net outlays over the planning period. An underlying ongoing operating deficit suggests that if nothing else changes over the longer-term outlays will exceed revenue inflows and available cash and service levels will be at risk (typically a council will struggle to be able to accommodate future asset renewal needs as and when required).

There are signs that indicate that some refinements to CoD’s financial related strategies are desirable in the next year or two in order to minimise the likelihood of financial sustainability and service level maintenance challenges down the track. Council needs to consider options to achieve a small positive underlying operating surplus result on an ongoing basis. In particular, possible opportunities for further refinement in CoD’s asset management planning processes and outcomes are desirable and this is discussed in Chapter 5.

5 Assessment of asset management

Chapter 2 of this report highlighted that local government service delivery is very asset intensive. A key general finding of Deloitte Access Economics' various local government financial sustainability work has been the need for councils typically to give greater consideration to longer-term needs and implications and improve their asset management planning considerations. Asset management plans help councils identify warranted future asset management expenditure and therefore plan to have capacity to cost-effectively carry-out warranted and affordable maintenance of assets and renew and replace them as appropriate to maintain preferred service levels and manage associated risks.

The most significant source of risk for councils typically is likely to be associated with estimating asset renewal outlay needs. It is difficult to financially model such needs because there is often a degree of discretion and subjectivity regarding the timing and scope of renewal works. This is primarily due to uncertainty around trade-off choices between service levels and long-run costs and councils' appetite for risk. Councils need to have due regard to affordability, i.e. long-run financial sustainability projections, in making such choices. What a council can afford is not necessarily equivalent of course to what it will need to expend in order to maintain preferred service levels. The key issue, as already emphasised, should be whether a municipality can maintain a satisfactory operating result ratio over time - and the long-run implications for asset renewal and service levels.

In all Australian states now other than Victoria, local governments are required to prepare asset management plans for all major classes of assets but this is not yet a requirement in the Northern Territory. At their most simple, asset management plans include forecast annual capital and maintenance expenditure forecast as warranted over a (for example) 10-year period necessary to achieve/maintain preferred service levels. Expenditure estimates consistent with asset management plans need to be accommodated in an entity's long-term financial plan in order to assess financial implications.

For financial planning purposes it is often useful to distinguish in asset management plans between forecast capital expenditure needs for new, additional assets and replacement assets. New additional assets result in provision of additional or upgraded services and lead to additional long-run operating costs (additional depreciation and maintenance). Replacement assets on the other hand simply (broadly speaking) maintain existing services and are unlikely to result in any significant real increases in future depreciation and maintenance costs (they replace assets that were already being depreciated and maintained).

The preparation of asset management plans and their use in informing decisions is critical in the optimal provision of ongoing service levels by a council. They need not be particularly technical or comprehensive. Many councils struggle to prepare sound asset management plans believing they need more data and analysis. Often a simple readily prepared plan is adequate and appropriate, particularly given long-run uncertainties. CoD is working on the development of asset management plans but these are not yet finalised. Staff believe current expenditure forecasts accommodated in its long-term financial plan are likely to be broadly consistent with what is warranted and what asset management plans would reflect. Nevertheless, it is important that CoD commit to finalisation and adoption of asset management plans in the near future and keep them up to date thereafter.

Asset management plan expenditure projections need to have regard to trade-offs between such factors as service level preferences, risk and long-run affordability. Financial projections and their associated implications should be carefully considered therefore not just by asset management employees but by senior finance staff too before draft plans are presented to council members for consideration for adoption. Trade-off options and their implications need to be determined by council members before asset management plans are finalised

It is important that a council's long-term financial plan is based on expenditure projections indicated in its asset management plan and the asset management plan is regularly reviewed and updated (say at least every 3 years) to take account of changing circumstances and updated information.

It is also important that the same asset replacement value estimates are used for asset register accounting purposes (in circumstances where asset values are based on replacement costs) and in asset management plans. Likewise, useful life estimates. Asset replacement timing proposed in an asset management plan should be consistent with remaining useful life estimates in the asset register. Many councils find preparation of an updated asset management plan leads to revision of asset register remaining useful life estimates. Australian accounting standards require annual review of asset useful lives.

Asset management performance is currently monitored by CoD by comparing annual asset renewal expenditure relative to depreciation. This financial indicator, commonly known as the asset sustainability ratio, is mandated for application by local governments in some other states. As highlighted in Chapter 3, Appendix A (Section A.2.4 and Appendix B (Item B.7), Deloitte Access Economics has reservations as to the reliability of this indicator. It prefers an indicator based on comparing actual or proposed asset renewal expenditure relative to that proposed in an adopted asset management plan. Use of this methodology would place additional emphasis on maintaining reliable asset management plans.

6 Assessment of borrowing needs and capacity

In undertaking its various local government financial sustainability inquiry work, Deloitte Access Economics has often noted that local government debt levels are extraordinarily low relative to the asset intensive nature of council services and the relative security of councils' income. In fact, we have often claimed that too many councils are 'debt averse' and are likely to need to make greater use of debt if they are to appropriately address affordable asset management needs and charge ratepayers appropriately (neither too much nor too little) on an inter-generationally equitable basis over time, relative to the services available.

More borrowings are not likely to help a council in the medium to longer-term that has a significant underlying operating deficit it cannot readily or is unwilling to address. Borrowings are not income and over time, costs need to be offset by income. What borrowings do is allow timing mismatches between expenditure and income to be accommodated. For example, they allow large outlays associated with acquisition of major capital works to be met and then paid for over time (through loan repayments) by the beneficiaries of the services they generate.

If a council is operating sustainably over the long-run then it should generally on average generate about enough cash for asset renewal as required (since revenue is being raised to offset depreciation of existing assets). It would still (on average) need to raise debt as a result of purchasing new or upgraded assets. (That is, it would not generate sufficient cash from depreciating existing assets to fund both their replacement and the acquisition of new additional ones). The alternative to borrowing would be to save for them but this effectively would mean that existing ratepayers would need to pay more than the cost of the service they're getting. This is why it is often claimed that use of borrowings can assist in promoting inter-generationally equitable rating.

Asset renewal backlogs often arise because councils that are in a reasonable or better financial position seek to acquire new assets and keep debt levels very low. The effect of doing this is often that they compromise their capacity to carry out asset renewal when required.

The above doesn't mean a council should automatically borrow whenever it purchases a new asset. There's no point in borrowing in the short-run if an entity has plenty of cash on hand. It does mean though that if a council is charging fairly over the long-run, that it is likely as a consequence of acquisition of new assets, to be required to borrow at some time in future (at least for a share of these costs) if it also wishes to have capacity to carry out timely asset renewal whenever so warranted.

It is also important to recognise that raising borrowings is unlikely to assist a council in addressing financial sustainability challenges per se. Acquisitions associated with the borrowing will typically result in higher long-run operating costs (depreciation and ongoing operations and maintenance expenses and interest expenses associated with the borrowing). Borrowings may help improve financial sustainability if they were necessarily raised to fund acquisition of assets that will lead to lower long-run operating costs (e.g. possibly replacing old inefficient plant or funding a new proposal that will generate a revenue stream in excess of operating costs).

The CoD utilises the debt servicing ratio indicator to monitor the reasonableness of its levels of borrowings. Appendix B sets out reasons why Deloitte Access Economics prefers to rely on the net financial liabilities ratio result in assessing a council's net debt levels.

CoD has very low levels of borrowings relative to its income. It also has extensive financial reserves. In fact, its current long-term financial plan forecasts that its net financial liabilities ratio will remain negative (i.e. it will have more net cash and investments than aggregate borrowings and other current liabilities in all years of the plan other than in 2022/23 when a significant peak in capital expenditure is proposed).

We are comfortable with guidance provided to SA councils by the Local Government Association of South Australia which suggests a well-managed financially sustainable council could comfortably manage with a net financial liabilities ratio of 100% or more.[8] We are not aware of any factors that would suggest that a lower target ceiling would be more appropriate for CoD.

If CoD's extensive cash holdings associated with externally and internally restricted reserves were ignored and its net financial liabilities ratio was calculated based on just unrestricted cash holdings the result would still be very low. The highest ratio over the 10-year financial plan (2023/24) is estimated at about 10%.[9]

The prime issue for CoD is not its current borrowing level but its projected ongoing operating result. If it could improve its underlying operating result on an ongoing basis it certainly has capacity to borrow more if need be.

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[8] See SA Local Government Association Financial Sustainability Information Paper no.9 – Financial Indicators and also Information Paper 10 - Debt both available at http://www.lga.sa.gov.au/webdata/resources/files

[9] In calculating this estimate we have ignored forecast provisions as it is assumed that provisions are offset by restricted reserves.

7 Rating levels

Table 2.1 highlighted that rate revenue was CoD's prime source of revenue in 2016/17. Its long-term financial plan does not envisage this scenario changing over the next 10 years. Its level of rates as a source of income in 2016/17 (63.1%) is consistent with that of SA councils in aggregate in 2014/15 (64.9%).[10]

Deloitte Access Economics has undertaken various work regarding local government rating previously (including a rating review for CoD in 2010). It is our view that council rates are a sound basis for generating a large share of local government revenue. It is nevertheless important that appropriate regard is had to the characteristics of the ratepayer and property base and taxation principles in designing a local government rate structure.

In setting rates councils need to have regard to equity considerations including capacity to pay. Whilst comparisons of rating levels between councils can be useful it is important to recognise that the average level of council rates can and does vary between councils for a variety of reasons (including relative differences in service levels and responsibilities and the impact of population density and commercial and industrial development). It is our view that comparisons of average residential rating levels are usually more meaningful than comparisons of overall (i.e. inclusive of commercial, industrial and farming properties) average rates payable or other comparative rating factors.

Table 7.1 below shows a comparison of CoD average residential rates and income relative to average residential rates and income in South Australia in 2014/15. Income data has been included as it is generally recognised as the best measure of capacity to pay. Deloitte Access Economics is reasonably familiar with the availability of Australian local government financial information but is not aware of average local government residential rating information being publicly available other than for SA.

[10] Refer SA Local Government Grants Commission Database Report 2014/15, Report 2, available at https://www.dpti.sa.gov.au/local_govt/LGGC

Table 7.1: City of Darwin and Average SA 2014/15 average residential rates and income

Jurisdiction	Average residential rates 14/15[11]	ABS median income	Rates as % of ABS annual income
City of Darwin	$1,440[12]	$55,317[13]	0.026%
All of SA	$1,417[14]	$46,050[15]	0.031%

Source: City of Darwin

The CoD advised that its average residential rates rose from $1,312 in 2012/13 to $1,535 in 2017/18. This represents an increase of 17.0% over the five-year period. The Darwin CPI movement over the past 5 years has been 9.6%.[16] The increase over the past 5 years closely follows the assumed projection in CoD's long-term financial plan (1.5% above CPI).

For comparison purposes the average residential property in the City of Adelaide incurred council rates of $1,602 in 2016/17 and average residential rates in other capital cities in that year varied from $1,098 (Sydney) to $2,218 (Hobart) (all inclusive of waste management charges where applicable).[17]

There are of course various factors as to why average council rates may vary between councils and between regions. Nevertheless, having regard to capacity to pay considerations it would appear that average residential rates applicable in the City of Darwin are not excessive at least compared to the average in South Australia.

Councils need to strike a balance in setting the level of council rates that has regard to ratepayers' service level preferences, associated rating affordability and long-term financial sustainability.

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[11] This is the most recent year for which SA Local Government Grants Commission data is available.
[12] As provided by City of Darwin. It also indicated that average residential rates rose to $1,466 (+1.8%) in 2015/16, $1,506 (+2.7%) in 2016/17 and $1,535 (+1.9%) in 2017/18.
[13] Median total income (excl. Government pensions and allowance), refer http://stat.abs.gov.au/itt/r.jsp?RegionSummary&region=71000&dataset=ABS_REGIONAL_LGA&geoconcept=REGION&maplayerid=LGA2014&measure=MEASURE&datasetASGS=ABS_REGIONAL_ASGS&datasetLGA=ABS_REGIONAL_LGA&regionLGA=REGION&regionASGS=REGION
[14] As per Report 6, SA Local Government Grants Commission Database Reports. Average metropolitan rating levels are slightly higher and average rural and regional levels slightly lower than this overall average.
[15] Median total income (excl. Government pensions and allowance), refer http://stat.abs.gov.au/itt/r.jsp?databyregion#/
[16] Refer ABS Table 640103.
[17] See Table 5.2, 'City of Adelaide – Review of Rating and Revenue', report of Jun 2017 prepared for City of Adelaide by JAC Comrie Pty Ltd.

8 Review of selected Council policies

In accordance with the project brief some specific CoD policies were examined. Those we were asked to review were as follows:

- Borrowing Policy;
- Investment Policy; and
- Financial Reserves Policy.

Apart from a small typographical error (towards end of p.2 of the Borrowing Policy the word 'revenue' should read 'reserve') we were generally comfortable with the content of the policies. They reflect what was traditionally seen as good local government practice.

It was particularly pleasing to see that Council's Financial Reserves and Borrowing Policy specifically allowed for and recognised the merit of 'internal borrowing' from financial reserves. There is no point in holding money for a future need if at the same time borrowings otherwise would need to be raised. The interest cost (and possible other fees) associated with borrowings will inevitably exceed the interest earnings on investment funds (at a similar point in time with similar risk over a similar duration). A council would therefore make a saving by utilising internal reserves even if it was necessary at some point in time in future to borrow funds to top up the reserve to meet needs.

Council's long-term financial plan forecasts the raising of over $15M in borrowings over the ten years beginning in 2016/17. In practice the majority (if not all) of this money could of course be raised from running down CoD's unrestricted cash holdings and use of internal borrowings from reserves. Similarly, it forecasts outstanding debt of $5M at the end of 2016/17 which its cash holdings suggest did not need to be raised if available cash had instead been run down.

Council's borrowing policy could be revised having regard to the content of this report. For example, as highlighted elsewhere we favour use of the net financial liabilities ratio rather than the debt servicing ratio specified in that policy. That policy also suggests that the term of any borrowing should generally not exceed the expected life of any asset acquired as a result. Generally, we would argue that a council should manage its financial affairs holistically and not necessarily link borrowings to the purchase of specific assets. (Borrowings should simply be raised because cash is needed.) Ideally in order to minimise risk a council should have a range of fixed and floating rate borrowings with a range of maturities (which could be rolled over if more cash was needed). Floating rate borrowings have the advantage typically of allowing outstanding balances to be run down when surplus cash that would otherwise be invested is available.

Deloitte Access Economics' experience is that many councils' practices regarding investments, borrowings and use of reserves have followed approaches consistent with those specified in CoD's related policies. We have often recommended that councils develop more sophisticated debt, investment and treasury management policies to reduce risk and net interest costs. It is suggested that CoD consider developing a treasury management policy. The South Australian Local Government Association developed guidance papers on debt and also on treasury management (the latter includes a draft treasury management policy) in response to findings of the 2006 Local Government Financial Sustainability Inquiry undertaken by (then) Access Economics.[18]

[18] SA Local Government Association Financial Sustainability Information Papers No. 10 - Debt and No. 15 Treasury Management are both available at http://www.lga.sa.gov.au/webdata/resources/files

9 Review of financial governance

A critical factor that facilitates ensuring a council's ongoing financial sustainability is to have a council's members and management understand and embrace their financial governance responsibilities. In response to the 2006 South Australian Local Government Financial Sustainability Inquiry the South Australian Local Government Association prepared a paper to help South Australian councils in this regard.[19] It identifies 13 keys for best practice financial governance under the following four theme areas;

1. Supporting sound financial decision making;
2. Ensuring affordable services to the community;
3. Guiding funding and financing; and
4. Facilitating performance monitoring and review.

Characteristics identified in the above paper are consistent with factors typically highlighted in this report. The paper does stress in particular the importance of '*Ongoing education and training such that all Council Members understand and fulfil their financial governance responsibilities.*' It also emphasises ensuring that '*Budget and financial information presented for Council deliberation is at a strategic level, succinct and easy to follow'.*

In preparing this report we have not had the opportunity to interact with CoD council members (a workshop is planned for discussion of the finalised report with council members). Our experience elsewhere is that council members are typically keen to be financially responsible but sometimes unsure of appropriate financial strategies for their circumstances. Even council members with strong business management experience sometimes have trouble distinguishing as to why financial strategies applicable in a business environment may be less appropriate in a local government setting.

All councils need to ensure council members are provided with appropriate training and information to aid sound financial policies and decision-making. Council financial reports elsewhere for example are often too detailed to facilitate a strategic focus. Council reports, its annual report, budget and strategic planning documents all need to ensure that key current and forecast long-term future financial projections and their implications are understood and kept front of mind. It is important also that these key messages are conveyed clearly to the community and opportunity for feedback provided wherever appropriate.

Council has an audit committee and its responsibilities appear to be well structured and managed. An audit committee can provide comfort and support to an elected council in helping it be satisfied that decisions are

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[19] SA Local Government Association Financial Sustainability Information Papers No. 23 - Financial Governance available at http://www.lga.sa.gov.au/webdata/resources/files

being made having appropriate regard to sound and relevant financial policy frameworks.

10 Conclusions

The indications are that CoD is currently in a reasonable financial position relative to many local governments Australia-wide. It has good systems and capacity and is not under any immediate financial constraint. Indications are though that ongoing financial sustainability challenges could possibly emerge in future. The finalisation of the preparation of asset management plans for all major classes of assets and an updated long-term financial plan that incorporates this impact and also the long-run financial implications from changes in street lighting arrangements and other intervening developments should provide a clearer indication of financial challenges.

It is possible that CoD will need to consider opportunities to raise further revenue (over and above the impact of inflation) or reduce operating expenditure over the next few years. Any material reductions in operating expenditure levels that cannot be achieved by way of efficiency improvements are likely to necessarily adversely impact on service levels, at least over the longer-run. Any council looking to improve financial sustainability needs to review its range and level of services and not just options to increase revenue.

It is important that CoD's management and elected body focus on longer-run financial projections when considering strategic priorities and in annual revenue-raising and expenditure decisions. A review of the financial indicators that Council reports projected performance against and targeted results aspired to be achieved may assist.

In order to be able to make sound inferences it is important that projected financial data is robust and reliable. In particular asset accounting data needs to be kept up to date including reliable estimates of asset replacement costs, useful lives, annual depreciation, residual values and renewal timing needs.

The issues and opportunities identified through this report where possible improvements may be desirable are consistent with those commonly found with other councils. Our experience elsewhere is that such improvements can normally be satisfactorily addressed and councils previously in similar circumstances to those that CoD is in currently have been able to make relatively modest ongoing refinements over several years and in doing so secure their long-term financial sustainability.

11 Recommendations

It is recommended that the City of Darwin:

1. Review financial indicators and targets that it applies to monitor assessments of financial sustainability performance having regard to commentary in this report and that performance against the selected targets be regularly reported to Council.

2. Commit to maintaining ongoing financial sustainability and adjust its plans and annual proposed revenue raising and expenditure whenever necessary to ensure projected future financial performance is consistent with this objective.

3. Have careful regard to financial sustainability in all of its annual budget and other revenue raising and expenditure decision-making processes. To assist it is suggested that steps be taken to raise the profile of a focus on ongoing financial sustainability and that a brief assessment of Council's financial sustainability status and projections be included in its annual budget and annual report and with more detailed assessment included in its long-term financial plan.

4. Ensure annual updates are undertaken of its long-term financial plan and that the plan be consistent with other Council corporate and strategic plans and achievement of appropriate financial sustainability targets and be used as a basis for setting the annual budget.

5. Finalise the preparation of asset management plans for all of its major classes of assets and that such plans clearly show forecasts of new and replacement asset capital and maintenance expenditure requirements over the next 10 years to achieve specified preferred and affordable service levels and acceptable levels of risk with such plans to be revised and updated at least every 3 years.

6. Ensure for financial reporting and asset management and financial planning purposes that all major classes of assets are regularly revalued (say every 3 years) and that estimates of asset remaining useful lives are reviewed annually and that methodology used to calculate depreciation is appropriate for the circumstances.

7. Develop a Treasury Management Policy and review its Investment, Borrowing and Financial Reserves Policies in the context of this new policy.

8. Periodically (at least once during the life of each elected council) review its financial governance arrangements and update both financial governance policies and practices as appropriate.

Appendix A: Local government financial sustainability factors and guidelines

A.1. Distinguishing characteristics of local governments

Measures applied to assess an entity's financial circumstances and outlook need to have regard to its operating environment. Compared with other spheres of government local governments typically:

- Are very 'asset intensive' in fulfilling their roles and responsibilities. They invariably have a large stock of assets relative to annual income. Their assets are in the main infrastructure (e.g. roads) and other long-lived assets such as buildings. These assets gradually wear out over time and local governments need to plan for their ongoing maintenance and replacement if they wish to see service levels maintained.
- Have relatively stable and predictable levels of annual (particularly operating) incomes and expenses. Their annual revenues and outlays are far less affected by peaks and troughs in economic conditions than is the case for the Commonwealth or State governments. Generally, they have a reasonable degree of control over the range and levels of services they provide and the outlays they incur. Some local governments are more dependent on receiving ongoing grants from other spheres of government than others but the main grant programs are relatively secure on an ongoing basis or at least for a defined period of years.

The above factors mean that local governments can and need to ensure their financial strategy and annual budget decisions are based on medium/longer term planning horizons. They also mean that some financial measures and targets commonly applied in assessing financial performance of other governments and other entities may be less appropriate in a local government context. That is not to say though that all local governments should necessarily adopt similar financial strategies. For example, what may be appropriate for a local government with a large and rapidly growing population may not be for a smaller rural council with a declining population.

A.2. Assessing local government financial performance and outlook

Deloitte Access Economics prepared comprehensive financial sustainability inquiry reports at the local government sector level in most states between 2005 and 2008. It observed then that many councils' budget decisions were focussed primarily on generating particular levels of inflow receipts that would enable them to accommodate immediate or near future outlay proposals. That is, budgets were set on a basis of balancing 'cash in' and 'cash out'. This is a simplistic approach to budgeting and potentially a problematic one for a sector that is responsible for managing services from a large stock of long-lived assets. Deloitte Access Economics observed then that there was much less concern in annual decision-making as to the relationship between underlying long-run operating revenue and underlying long-run operating costs (inclusive of depreciation).

The asset-intensive nature of local governments means that there will be times where councils face the need for large capital outlays. A focus on short-term cash costs runs the risk for example that:

- during periods of below average asset renewal need councils generate less revenue than is sufficient to offset long-run costs (or if they do raise sufficient revenue they are tempted to spend short-run excesses on additional services) and then struggle to be able to accommodate subsequent peaks in asset renewal outlay need; and
- councils believe that they need to raise more revenue to accommodate peaks in new asset acquisition when it arises which may adversely impact on ratepayer intergenerational equity. Deloitte Access Economics has also found that councils in such circumstances often also prefer to reduce capital expenditure on asset renewal to help realise cashflow for new assets.

Improved long-term financial planning by councils over the past decade has assisted them to better recognise the above issues, determine preferred affordable service levels and set appropriate financial strategies. There has been significant progress made in these regards by local governments in all states but progress has varied between local governments (and between local government sectors in different jurisdictions).

Deloitte Access Economics believes that there are four key considerations in assessing the financial outlook for a council and determining an appropriate financial strategy. These are briefly discussed below.

A.2.1. Underlying Operating Result

The asset-intensive nature of local government service provision means that depreciation can be a large part of the total operating expenses of a council. It can often represent 20% or more of a council's total operating expenses. It is not a cash cost but needs to be considered in financial decision-making.

If a council can maintain a positive underlying operating result (that is operating revenue (net of capital revenue) in excess of operating expenses including depreciation) then sufficient revenue is being generated to offset the cost of service provision. This means effectively that ratepayers and service recipients in any year are collectively 'paying their way' and that revenue generated from offsetting depreciation should help ensure that, on average over time, sufficient net cash inflow is generated to substantially accommodate asset renewal outlay needs.

The prime objective of a council's financial strategy should in usual circumstances be to ensure that it achieves and maintains a small underlying operating surplus on an ongoing basis. If it can do that then it should be able to maintain service levels and address asset management needs as and when required.

Generally, Deloitte Access Economics would recommend targeting achievement of a small underlying operating surplus (say of the order of 5% of operating revenue but possibly more or less depending on a local government's circumstances and outlook)) over a break-even result to help offset risk and uncertainty.

Depreciation typically represents about 20% to 25% or more of a council's total operating expenses and is difficult to reliably measure. It is always an estimate. A small surplus helps offset the impact from under-estimating depreciation expenses that consequentially may lead to inadequate funds being available for future asset renewal. A high ongoing surplus may indicate that a council is over-charging current ratepayers relative to the cost of the services it provides and future considerations.

Deloitte Access Economics' preferred basis for determining a council's operating result involves adjusting income recognised in accounting reports to net out income received to help fund new capital asset acquisition (capital revenue). We also favour a focus on 'underlying' performance by discounting the reported operating result for one-off or temporary factors.

The Underlying Operating Result Ratio expresses the Underlying Operating Result as a percentage of an entity's operating revenue (net of capital revenue).

A.2.2. Service levels

A council's operating result is a function of both revenue and operating expenses. Operating expenses are driven by service levels. Any assessment of a council's financial sustainability is predicated on the range and level of services provided.

It is critical that councils have regard to impacts on financial sustainability when determining service levels. Acquisition of a new additional asset, even if funded by a grant, will lead to higher subsequent operating costs for a council in the form of ongoing maintenance and depreciation.

Any council looking to improve financial sustainability needs to review its range and level of services and not just options to increase revenue. Many councils for example have been able to reduce long-run operating costs by reviewing the hierarchy classification of their road networks. It is often possible to generate long-run savings by maintaining some roads to a lower service level and extending periods between renewal treatments.

Ultimately a council needs to settle on a range and level of services that is consistent with the willingness and capacity of ratepayers and service recipients to pay for them (net of any likely ongoing grants or other sources of operating income). All councils face trade-off choices between higher levels of long-run service provision and associated higher long-run levels of revenue raising or lower levels of long-run service provision and lower long-run levels of revenue raising.

A.2.3. Extent of Use of Debt

If a council always operates in a financially sustainable manner then it should on average generate about enough net cash inflow to accommodate asset renewal needs over time. It would not though have the net cashflow to accommodate both large scale outlays on new assets as well as asset renewals unless it was operating with a considerable underlying operating surplus. Likewise, there may be peaks in asset renewal need that generate cashflow challenges for councils that are now operating sustainably but haven't always done so previously.

The asset-intensive nature of local government service provision means that many councils, and particularly those that must provide for future growth, are likely to need to make extensive use of debt in order to address capital expenditure requirements. This is particularly so if they also wish to equitably maximise the value of service levels they provide to ratepayers and service recipients and charge them for over different time periods. Deloitte Access Economics' various financial sustainability inquiry reports have invariably concluded that many councils were and still are under-utilising debt relative to their circumstances to the detriment of their communities.

Deloitte Access Economics preferred basis of assessing the extent of use of debt is by measuring net financial liabilities (total liabilities less financial assets) expressed as a ratio of operating income. Guidance produced by the Local Government Association of South Australia suggests that a well-managed, financially sustainable council with good long-term planning could comfortably operate with a net financial liabilities ratio of 100% or more. It also emphasises that use of debt needs to have particular and considered regard to a local government's circumstances and outlook. Deloitte Access Economics agrees in both instances.

Under a scenario where a council had net financial liabilities of say 100% then annual net interest costs are still likely to be about 5% of its total operating expenses based on current borrowing rates. At the same time, it needs to be emphasised that borrowings are not income and that more borrowings are not likely to help a council that has a significant underlying operating deficit it cannot readily address.

Many councils still borrow for specific purposes whilst maintaining substantial cash holdings for other future purposes. There is no need to do so. Such practices lead to both higher net interest costs and greater interest rate risk exposure. Deloitte Access Economics favours a holistic approach to treasury management where cash holdings are utilised to reduce the level of outstanding borrowings at any time (even temporarily) and defer the need to raise borrowings wherever possible. Councils can maintain accounting records (and 'internal borrowings' arrangements as preferred) to recognise the various past events and future commitments and proposals that collectively help determine and explain the rationale for their financial assets and borrowings balance whilst still managing funds holistically.

Furthermore, Deloitte Access Economics sees little need for councils in most circumstances to maintain high stocks of 'working capital'. Councils can readily establish borrowing facilities that enable then to access additional short-term financing if needed to accommodate patterns of cashflow.

A.2.4. Asset management

Deloitte Access Economics has some concerns as to the consistency and objectivity with which councils determine asset renewal needs. Many councils claim to have substantial asset renewal backlogs. A backlog is a function of, amongst other things, preferred service level decisions and revenue raising and use of debt strategies. Many councils that claim to have significant asset renewal backlogs could have previously addressed these needs by spending less on other services, or raising more revenue and if need be raising borrowings. The fact that they have not done so, often means that they preferred this outcome to the alternatives. Some councils for example have maintained satisfactory underlying operating results on an ongoing basis yet claim they have limited capacity to address asset renewal needs. This is often because they have preferred to also acquire new assets and have not been willing to raise additional consequential borrowings.

Councils often report asset renewal relative to depreciation for the corresponding period (sometimes called the asset renewal ratio or asset sustainability ratio). Deloitte Access Economics has reservations regarding the meaningfulness of comparing asset renewal outlays with annual depreciation. It should not be assumed that asset renewal expenditure of the order of about 100% of the level of annual depreciation is necessarily desirable in any period (or even over the medium-term). Local government infrastructure can have very long lives and asset renewal needs can vary significantly between periods. A council that has experienced a lot of growth over the past decade, for example, may find that it currently has relatively modest asset renewal needs relative to annual depreciation expenses. Also, service level needs can change as a result of for example demographic change, freight movement pattern changes or community preferences. It also should not be assumed that existing assets will always need to be replaced at the end of their useful lives.

If a council maintains (and projects that it can in future maintain) a satisfactory underlying operating result then it should have the capacity to undertake asset maintenance and renewal (consistent with current service levels) on an ongoing basis. This is true even if it needs to borrow to do so.

Asset management performance should be assessed based on comparing actual activity with what a well-prepared asset management plan suggests is or was warranted in regard to maintenance and renewal levels. In making any such assessment it is essential though that the asset management plan has been based on service levels that are affordable over the long-run and not just a "wish list" of what councils would like to do if funds were available.

A.3. Concluding comments

In order for a local government to confidently assess whether it needs to consider seeking a real increase in rate revenue or reduction in service levels it first needs to:

1. have been able to reasonably reliably determine its base case likely underlying long-run operating revenue and underlying long-run operating costs (that take account of strategic priorities and preferences) and therefore whether it has a projected underlying ongoing operating deficit;
2. determine affordable preferred service levels and whether its community would prefer higher or lower service levels and the associated implications for rate levels;
3. have determined a responsible approach to the use of debt relative to its circumstances;
4. have developed asset management plans that are based on affordable, preferred service levels and cost-effective outlays consistent with such service levels and appropriate corresponding risk management practices; and,
5. consider the potential to realise efficiency gains which could reduce costs without impacting on service levels.

Appendix B: Review of financial indicators used by the City of Darwin

In its 2016 to 2026 long-term financial plan the City of Darwin assesses its projected financial performance against a range of financial indicators (refer pp. 34 & 35). Those indicators and Deloitte Access Economics assessment of them and associated targets are discussed below.

B.1. % of Rate Debtors Outstanding

(Target < 5%)

This indicator is intended to measure Council's effectiveness in recovering debts legally owed to it. It is appropriate to monitor ongoing outstanding rates. It is usually in the interests of ratepayers for a council to pro-actively monitor arrears and work sympathetically with ratepayers to achieve recovery. Generally, the more prompt and pro-active a council is in this regard the greater the likelihood of recovery and minimisation of ratepayer hardship. The ratio can of course vary for reasons beyond a council’s control, e.g. as a result of an economic downturn.

This indicator is not seen as particularly relevant to financial sustainability considerations. A council’s rate arrears are effectively a debt against the property and can usually be recovered through its forced sale if necessary. Councils usually have access to sufficient cashflow (or can likely borrow if necessary) such that arrears owing are not likely to present significant financial challenges for a council.

B.2. Debt Servicing Ratio

(Target < 5%)

This indicator is designed to show what proportion of revenue is required to fund loan repayments. It or similar is commonly applied by councils elsewhere.

The indicator is simple to comprehend but it does have shortcomings in providing meaningful assessments of debt levels. The calculated ratio will be influenced to a large degree by the preferred duration of any loan and its repayment terms. Extending the period over which repayments are made would for example result in a lower indicator ratio. All things being equal though it would instead make more sense to repay a loan as quickly as forecast available cashflow would permit.

As highlighted in the body of the report (Section 6) and in Appendix A (Section 2.3), Deloitte Access Economics prefers to consider the net financial liabilities ratio in assessing the extent of a council’s borrowings.

B.3. Liquidity

(Target > 1:1)

This indicator is designed to measure whether Council has the cashflow ability to pay its debts as they fall due (presumably over the next 12 months) expressed as a factor of one.

This indicator or similar is commonly applied by businesses in the private sector. Local governments have more control over their revenue streams than is typically the case of private businesses. Deloitte Access Economics favours councils repaying debt wherever possible rather than stockpiling cash for future predicted outlays. Where councils can access additional borrowings at short notice to accommodate unexpected cashflow needs it can make sense to operate with a lower liquidity ratio than '1:1'. Given that local governments in the Northern Territory need Ministerial approval to borrow it is reasonable to monitor this ratio and the City of Darwin's target is appropriate.

B.4. Rates Ratio

(Target 60-70%)

This indicator is designed to measure the Council's ability to cover its own day to day expenses through its own tax revenue.

It is reasonable to monitor this ratio for the reasons stated above (it is a controllable source of revenue) and particularly to monitor trends over time. There is though no particular right target ratio outcome. Higher and lower ratios both have positive and negative characteristics. Councils should raise revenue from other sources as appropriate and specifically raise fees and charges generally sufficient to offset associated costs for goods and services wherever possible and have regard to market prices of substitutes wherever possible. Grants should also be pursued subject to consideration of longer-term implications. Rating levels should then be set to ensure that aggregate operating revenue is sufficient to achieve the operating surplus target (see below) regardless of whether this means the rates ratio rises or falls.

B.5. Operating Surplus / (-Deficit)

(Target: Break Even)

This indicator (operating revenue less operating expenses) is designed to provide information on the result of ordinary operations and its calculation does not include capital income. CoD notes that 'Trend analysis may enable the Council to determine if the current level of operations can be sustained into the future' (p.34 of its long-term financial plan).

The Operating Result is considered by Deloitte Access Economics to be the key to assessments of ongoing financial sustainability.

The CoD suggests (p.35 of its long-term financial plan) that it considers a target of a 'breakeven' operating result to be 'relatively conservative as some income/contributions for capital purposes inevitably goes towards making good depreciation/consumption of existing assets'.

Deloitte Access Economics appreciates that a proportion of 'capital revenue' (not included in operating revenue or in above calculated operating surplus) may effectively help fund capital works such that a council would not need to raise operating revenue to offset otherwise warranted asset renewal works. We would normally consider this quantum to be relatively modest.

As indicated elsewhere (see Section 4 of report and Appendix A (Section 2.1)) we would normally suggest an underlying operating surplus target of the order of 5% but appreciate that a higher or lower target may be appropriate. Given the uncertainties of estimates of future asset management needs, the inherent difficulty of reliably estimating depreciation expenses and uncertainties associated with future forecast growth rates and ongoing grant funding from other levels of government, we consider it prudent to aim for a small ongoing underlying surplus. Even if the above issues could be reliably predicted then all things being equal if a council achieved a long-run breakeven result the effects of inflation are such that revenue raised from offsetting depreciation charges is unlikely to be adequate over time to fully fund all asset renewal.

B.6. Operating Surplus Before Depreciation

(Target > Break Even)

This indicator is designed to provide information on the result of ordinary operations before depreciation.

It is appreciated that depreciation is a large non-cash expense but the value of this indicator is not clear. Deloitte Access Economics encourages councils to focus on accrual accounting costs (i.e. inclusive of depreciation) rather than just cash costs. Our past local government financial sustainability work suggests that a focus on cash costs is a factor in councils setting inappropriate revenue-raising and expenditure decisions and subsequently having difficulty in accommodating peaks in asset renewal needs.

B.7. Asset Sustainability Ratio

(Target > 50%)

This indicator is designed to indicate the extent to which Council is renewing its assets. It measures the ratio of asset renewal outlays relative to depreciation (as a percentage). It is widely used in other Australian jurisdictions. A target of 100% is often seen as appropriate as it implies that a council is renewing assets at the rate of their consumption. It is understood that CoD has set a lower target on the basis that its asset stock is relatively new.

Deloitte Access Economics' view is that it should not be assumed that asset renewal expenditure of the order of about 100% of the level of annual depreciation should necessarily be aimed for in any period (or even over the medium term). Asset renewal needs can be lumpy between periods and affordable service level preferences can change. For several years councils in South Australia were required to report performance for this indicator but it is no longer required as evidence suggested that the results generated (even cumulatively over several years) were not necessarily reflective of asset management performance. South Australian local governments are now instead required to report annual asset renewal expenditure relative to that identified in a council's adopted asset management plans. We support this change.

Limitation of our work

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