LOCAL GOVERNMENT FINANCES IN WESTERN AUSTRALIA

AN ASSESSMENT
BY
ACCESS ECONOMICS PTY LTD

FOR THE

SYSTEMIC SUSTAINABILITY STUDY

JUNE 2006

ACCESS ECONOMICS

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EXECUTIVE SUMMARY

This report presents our assessment of the current state of council finances in Western Australia.

We have focused on the picture in 2004-05, the latest year for which actual data are available, although we have also explored trends evident in preceding years.

Our assessments encompass 142 councils, although we do not identify individual councils when reporting our results. Instead, we present our results by council groupings.

WHAT IS THE CURRENT FINANCIAL POSITION OF COUNCILS IN WESTERN AUSTRALIA?

Findings:

Our analysis of council balance sheets shows that WA councils employ about $13 billion in capital, which is invested primarily in non-financial assets like infrastructure.

Overwhelmingly, ratepayer equity is the principal source of this capital. WA councils place very little reliance upon borrowings. In fact, on average, the financial gearing of WA councils at 30 June 2005 was substantially lower than the WA State government's.

Only 16 councils had net borrowings in excess of 5% of the capital they employed. 60 councils (or 42%) were net creditors, with holdings of unrestricted cash and securities exceeding their total liabilities.

Conclusions:

There is no evidence that WA councils suffer from any past over-reliance on borrowing. From this perspective, the balance sheets of WA councils are generally very strong.

WHAT IS THE CURRENT FINANCIAL PERFORMANCE OF COUNCILS IN WESTERN AUSTRALIA?

Findings:

A less comfortable picture emerges from an examination of council operating statements.

On average, WA councils registered operating deficits in 2004-05 that amounted to 4½% of their own-source revenue. By comparison, the WA State general government sector recorded an operating surplus in excess of 10%.

Across all WA councils, the operating deficit situation has shown signs of improvement over recent years, with the deficit ratio halving between 2001-02 and 2004-05. However, the reduction in council operating deficits in recent years has been achieved by councils' own-source revenues increasing significantly faster than their operating costs. Of itself, this may be symptomatic of the unsustainable nature of councils' current policies and cannot necessarily be relied upon going forward.

Only 49 councils (or 35%) had positive operating surpluses, with 7 councils recording surpluses in excess of 20%. Of the councils showing operating deficits, their average deficit was the equivalent of 17½% of their annual own-source revenue. 70 councils (or nearly 50%) had operating deficits in excess of 10%. Metropolitan councils on

average recorded the slightest of operating surpluses. The regional councils on average recorded sizeable operating deficits.

It is only when capital transactions are included in the analysis that the annual operating performance of WA councils can be reconciled with their comfortable balance sheet positions. On average, WA councils only financed just less than 3% of their annual net increase in capital employed in 2004-05 by borrowing. The remainder was financed internally. In each of the preceding three years, WA councils were net lenders in aggregate.

Only 59 councils (or just over 40%) were net borrowers in 2004-05. The remainder were either net lenders or they did not increase their capital employed at all.

Metropolitan councils recorded net borrowing ratios averaging nearly 10% in 2004-05, similar to the average ratio recorded by the above-average population growth councils. The largest net borrowers were the smallest councils. However, regional councils without large towns and declining population generally were substantial net lenders in 2004-05.

Conclusions:

A council's annual operating financial performance is sustainable only if the council avoids both excessive borrowing and operating deficits over the medium- to long-term.

Running operating deficits appears to be the norm in WA councils. Where operating deficits persist, indications are that rates revenue is insufficient to finance current operations. In fact, operating deficits indicate that a proportion of services consumed by current ratepayers is to be funded – one way or another – by future ratepayers.

By contrast, excessive borrowing is not the issue for WA councils. Rather than incurring debt in order to finance their annual operating deficits, most WA councils have been relying for some time instead on capital transfers (such as capital contributions, capital grants and the proceeds of asset sales) for this purpose. In effect, councils typically have been running surpluses on their capital account in order to fund deficits being run in their operating account.

Such capital surpluses are only possible by deferring capital spending on existing and new infrastructure and for which purposes the collection of capital revenue (such as capital contributions and capital grants) can only be justified. Hence, instead of the usual net borrowing (and accumulated debt) consequences of operating deficits, an infrastructure spending backlog seems likely to have emerged for many WA councils.

WHAT THERE ASSET-RELATED PRESSURES ON THE FINANCIAL POSITION AND PERFORMANCE OF COUNCILS IN WESTERN AUSTRALIA?

Findings:

In aggregate, the non-financial assets of WA councils were valued at just over $12 billion on 30 June 2005. Importantly, however, each council has a different combination of non-financial assets (and so infrastructure financing pressures).

In aggregate, in 2004-05, the annual capital expenditure of WA councils on the renewal or replacement of their existing non-financial assets fell $110 million short of the amount necessary to ensure that the service capacity of these assets remained unchanged. Such shortfalls involve shifting part of current ratepayers' share of the funding of infrastructure renewal or replacement onto future ratepayers.

As a result, councils only spent 75% or so of the amount required to maintain their non-financial assets at their current condition. This falls between similar estimates made previously for NSW councils (70%) and SA councils (90%).

Only 26 councils (or under 20%) are estimated to have spent at least the amount required to maintain their non-financial assets at their current condition in 2004-05.

The renewals performance varies widely among councils. This performance was generally better for metropolitan councils than for regional councils. The faster growing and largest councils display better results on average than declining population and smallest councils.

Once past renewals shortfalls are also taken into account, we estimate the total infrastructure backlog for WA councils to be in the vicinity of $1¾ billion. This is about 14% of the total value of council non-financial assets in WA, which compares with the 10% or so for the finding made for the NSW Inquiry.

108 councils (or close to 75%) are estimated to have infrastructure backlogs in excess of 10% of the written down value of their total non-financial assets at 30 June 2005.

Rather than redirecting capital funds to the financing of upgrading and expansion of their assets, our view is that councils instead are redirecting such funds to finance their operating deficits so as to avoid the usual borrowing consequences of operating deficits.

For this reason, we are convinced that, rather than incurring debt in order to finance their annual operating deficits, WA councils – like their NSW and SA counterparts – have for some time instead been diverting capital revenue (such as capital contributions, capital grants and the proceeds of asset sales) to this purpose.

Conclusions:

Council non-financial assets – particularly their infrastructure assets – are not being maintained or renewed to appropriate standards. Councils have been responding to budgetary stress in particular by postponing expenditure on maintenance and asset renewal/replacement. This has induced an ongoing annual asset renewals gap and an infrastructure backlog. Making matters worse is the fact that major components of council infrastructure are expected to reach the end of their usable lives in coming decades.

Councils should be increasingly dedicating their revenues from capital grants, contributions and asset sales proceeds to capital purposes.

Moreover, the long-run decline in council's reliance on borrowing needs to be reversed. External borrowing can be an appropriate financing source in the right circumstances, namely when it is used to fund the acquisition of new non-financial assets or the upgrading of existing assets (as distinct from funding routine maintenance and the renewal of existing infrastructure assets which both should be funded out of internally-generated cash flows).

Any limits on borrowing for the purpose of acquiring new infrastructure assets within the local government sector should be set – based upon expert advice and generally-accepted standards of prudence – by reference to a council's long-term financial capacity to service debt rather than an anti-debt mindset.

WHAT IS THE OUTLOOK FOR THE FINANCIAL CAPACITY OF COUNCILS IN WESTERN AUSTRALIA?

Findings:

Over the last four years, on a per-property basis, the annual percentage increase in the average rates bill has been two to three times the annual percentage increase in the CPI. This has been sufficient to finance some increases in levels of service as well as reduce council operating deficits.

69 councils or nearly 50% have grown their per-property rates collections over the last five years at an average annual nominal growth rate more than twice the State's annual CPI increase. Only 41 or just less than 30% increased their's by less than 1½ times the State's CPI.

Overall, we take this to be evidence that – unless it is clear that a council has a below-par rating effort – councils generally have been pushing the envelope when it comes to rates increases. In future, annual percentage increases in per-property rates collections at this level – let alone at higher levels – will justify ratepayer dissatisfaction.

Were lower-effort councils to match the effort currently shown by higher-effort councils, we estimate that total rates collections for those councils currently with operating deficits could increase by around $40 million or 6%.

An upward trend is also evident in the average cost recovery ratio of WA councils. Were lower-effort councils to match the effort currently shown by higher-effort councils, we estimate that total fees and charges for deficit councils could increase by around $44 million or 17%.

Conclusions:

Councils themselves must be able to raise at least a fair slice of the revenue they need to cover the costs of providing services to their communities. If they cannot, service standards must fall, or financial sustainability may be compromised – or both.

Overall, rates revenue is predictable and stable and allows for a fairly high level of local financial autonomy. We consider that the local government rating system generally meets the criteria of administrative simplicity and efficiency, and – if administered carefully – is capable of being vertically and horizontally equitable.

We estimate that WA councils with operating deficits could more than halve their operating deficit ratios if those among them with below-par rating and cost-recovery efforts lifted their effort. This would result in around an 11% increase in these councils' own-source operating revenue. In addition, if an appropriate framework were put in place, there is also scope for increased developer charges in those councils not yet fully exploiting this form of cost recovery.

Admittedly, there are large differences among councils in their access to any available additional financial capacity. In particular, councils relying more on grants from other governments and less on their own-source revenue only have access to relatively low levels of additional financial capacity.

However, whether some of the identified own-source revenue increases materialise even on average will depend importantly upon the policies adopted by councils themselves. Much depends upon the willingness of councils to exploit any opportunities available for increasing their revenue-raising effort and the extent to which they are prepared to contain rates concessions in future.

HOW SUSTAINABLE ARE THE LONG-TERM FINANCES OF COUNCILS IN WESTERN AUSTRALIA?

Findings:

On our estimates, just over one in every two councils in Western Australia require a substantial (i.e., greater than 10%) further increase in their own-source revenue to eliminate their underlying operating deficits. This assessment is after taking into account each council's additional revenue-raising capacity on the one hand and the costs likely to be imposed if they are to address any infrastructure backlog on the other.

On this basis, it is our assessment that the long-term finances of 83 WA councils are currently 'unsustainable'.

As we use the term, however, being classified as 'financially unsustainable' does not mean a council is in imminent danger of defaulting on its debt service obligations. That is, the financial viability of these councils is not necessarily being called into question. Rather, what we are flagging for each of these councils is that substantial or disruptive revenue (or expenditure) adjustments seem inevitable based upon continuation of current policies if their long-term finances are to be put onto a sustainable basis going forward.

The WA councils we classify as 'unsustainable' in this sense serve 21% of the State's population. This falls within estimates made previously for NSW councils (17%) and SA councils (50%).

Financial sustainability does not appear to be too much of a problem for metropolitan councils in WA, with only three such councils (or 10% of metropolitan councils) assessed as unsustainable.

Instead, the councils whose finances are most likely to be unsustainable in the longer term are mainly regional councils, and those with declining populations and small population bases at that. We have assessed 70% or so of each of these council groupings as financially unsustainable. Three-quarters of the councils we have assessed as being unsustainable are regional councils without large towns.

In WA, to an extent not evident in either NSW or SA, financial unsustainability is a problem particularly prevalent among smaller and/or declining population regional councils. This is evidence of a structural problem within local government in WA that is nowhere near as evident in NSW or SA (for example).

However, 31% of the largest councils and 45% of the above-average growth councils are also assessed as financially unsustainable. This suggests to us that more factors are at work in explaining the sustainability of a council's long-term finances than just whether it is small in size or has stagnant growth characteristics.

Conclusions:

The long-term finances of a majority of WA councils look unsustainable, when account is taken of infrastructure backlogs and despite the additional revenue-raising capacity many of them have because of their current below-par revenue efforts.

In fact, for these councils, the additional financial capacity they have is not sufficient either to eliminate their currently-observed operating deficits and/or address the infrastructure backlogs that they have been building up for some time.

The councils whose current policies seem unsustainable over the long term are mainly regional councils, which include most of the State's smallest and declining population councils. This is evidence of a structural problem.

In the absence of additional grant funding from other governments, our assessment is that the long-term finances of at least one in every two WA councils are unsustainable. For such councils, our assessment is that substantial rates increases (or disruptive expenditure cuts) – on top of the additional revenue-raising effort we have factored-

in for low-effort councils – will be required if their (existing and emerging) budgetary imbalances are to be corrected.

WHAT FINANCIAL GOVERNANCE REFORMS MAY BE NECESSARY WITHIN LOCAL GOVERNMENT IN WESTERN AUSTRALIA?

In our view, the prevalence of operating deficits and their frequent co-existence with substantial infrastructure backlogs are symptomatic as much of deficiencies in council spending and revenue policy frameworks – compounded by poor information and understanding of asset management – as they are of shortfalls in the level and escalation of grants from other governments and any past cost shifting.

The deficient policies and practices evident across local government in Australia at present include those relating to the under-funding of depreciation, the outdated measurement of asset values and depreciation, poor asset management systems and policies, and the inadequate monitoring and reporting of a council's financial position and performance.

Where financial governance is not well developed in councils, it is not surprising that there is a lack of understanding on the community's part of the true costs of current infrastructure and service commitments.

Improving such policies and practices would not only prompt councils to do more to ensure their own financial sustainability, but might also convince other governments that increasing grant funding to local government could after all be a prudent use of taxpayer funds.

Access Economics
June 2006

FOREWORD

In April 2006, Access Economics was engaged by the Systemic Sustainability Study to prepare an assessment dealing with aspects of three of the six matters specifically referred to in the Study's terms of reference, namely:

- a review of all WA council balance sheets and operating statements for the year ending 30 June 2005 in order to analyse and assess the overall viability and state of financial health of WA councils;
- the status of local government infrastructure assets, including compilation of a State-wide inventory of all such assets, their gross value, method of depreciation, replacement timing and cost of maintenance; and
- the adequacy of existing local government funding mechanisms, such as rates, debt, fees and charges, fines and the desirability of mechanisms identified from other jurisdictions, such as developer levies, product sales and business activities.

Our report to the Independent Panel appointed to undertake the Study is structured as follows:

- chapters 1 and 2 deal with the current financial position and performance of the WA local government sector;
- chapter 3 deals with infrastructure-related financial obligations on WA councils that are not directly evident in an analysis of a council's published financial statements;
- chapter 4 provides our assessment of the financial capacity of WA councils;
- chapter 5 provides our overall assessment of the financial sustainability of WA councils; and
- chapter 6 puts forward our recommendations as to how WA councils themselves could generally improve their financial health and governance.

CAVEATS AND DISCLAIMERS

We have undertaken what we describe as a 'fiscal' analysis of the finances of WA councils. This no only limits our consideration to financial matters, but also sees our analysis focus on big picture financial issues i.e., on key budgetary and balance sheet analytical balances.

We have relied upon financial data reported by councils and prepared in accordance with the accounting and financial reporting requirements embodied in the WA *Local Government Act* and the Australian Accounting Standards. While such data are audited at the individual council level, there is no check undertaken as to the consistency of reporting practices across councils.

Our assessment has involved a 'desktop analysis' only, with no follow-up or checking with individual councils. Of necessity, our analysis has been restricted to data that is readily available, with the exception of a survey we conducted to obtain information about the composition and value of council assets.

In instances where key data are missing or inadequate, we have had to rely on certain estimation procedures. We have implemented these procedures without any particular result in mind. Where we have exercised judgment (as is always necessary to complete an assessment of this kind), we have done so based on our experience with these types of assessments. When in doubt, our departures from published data if anything have erred on the conservative side.

Finally, we stress that the views expressed in this report are those of Access Economics, and do not necessarily represent the views of the Independent Panel.

ACKNOWLEDGEMENTS

Access Economics is grateful to the WA Local Government Grants Commission and the WA Local Government Association for providing access to their respective local government finance data bases, and to the officers of both organisations for assisting with the down-loading and interpretation of these data.

We are also grateful to those councils that responded to our asset survey, particularly given the relatively short notice and the busy time of the year.

GLOSSARY

capital employed	in the WA council context, means the sum total of the written down value of a council's non-financial assets, the value of its working capital and the value of its holdings of restricted cash and securities
capital transfers	mean the grants and contributions provided to a council for capital purposes
depreciation expense	means the annual decline in the value of a council's non-financial assets due to the usage (and so deterioration) of those assets
developer charges	mean (cash) capital contributions and (non-cash) asset donations made to a council
financial assets	mean assets that are in the form of financial claims on other economic units
financial assistance grants	mean the untied grants provided to councils by the Commonwealth government, which are in the nature of tax-sharing grants
financial capacity	means the sum total of the revenue (both operating and capital) that a council could mobilise through its (present and prospective) revenue-raising and financing policies
financial gearing	means the degree to which the capital employed by a council is obtained from debt sources as opposed to retained earnings (or equity) sources
financial governance	means the process by which an elected council meets its accountability obligations to its ratepayers for the sustainability of the council's long-term finances
financial performance	means the state of a council's annual operating statement, essentially involving the surpluses or deficits between its annual income and expenses, and between its annual revenue and spending
financial position	means the state of a council's balance sheet, and so the relative level – and composition – of its assets and liabilities
financial sustainability	means the extent to which a council's financial capacity is sufficient – for the foreseeable future – to allow the council to fund the spending that is necessary to meet both its existing statutory obligations and any associated spending pressures and financial shocks without having to introduce substantial or disruptive revenue (and expenditure) adjustments
infrastructure backlog	means the accumulated amount of past shortfalls in maintenance and renewals expenditure on existing assets relative to the expenditure that was necessary to keep these assets in optimum condition
net acquisition of non-financial assets for renewal/replacement purposes	means the actual renewals capital expenditure less the status quo renewals capital expenditure
net borrowing	means the situation where a council's annual transactions are financed by an increase in the council's net financial liabilities
net debt	means the total of a council's interest-bearing liabilities less its holdings of unrestricted cash and securities
net interest expense	means a council's total interest expense less any interest income on its holdings of unrestricted cash and securities
net financial liabilities	mean the net financial obligations of a council to other sectors of the economy, being total liabilities less its holdings of financial assets other than restricted cash and securities
net lending	means the situation where a council's annual transactions give rise to negative net borrowing and so a decrease in the council's net financial liabilities
non-financial assets	mean a council's inventories, land, buildings, infrastructure, equipment, furniture and fittings

operating deficit	means a situation where a council's total annual expenses (excluding losses on disposal of non-financial assets and losses made on the revaluation of financial and non-financial assets) exceed its total annual operating revenue, so that this portion of costs incurred in the year in question is transferred to tomorrow's ratepayers and not met by today's ratepayers
operating revenue	means a council's total annual revenue excluding capital grants, capital contributions, physical resources received free of charge, gains made on the disposal of non-financial assets and gains made on the revaluation of financial or non-financial assets
operating surplus	means the extent to which a council's total annual operating revenue exceeds its total annual expenses (excluding losses on disposal of non-financial assets and losses made on the revaluation of financial and non-financial assets), so that costs incurred in the year in question are at least being met by today's ratepayers and not being transferred to tomorrow's ratepayers
own-source revenue	means revenue that is not received in the form of grants from the other tiers of government
renewals capital expenditure	means the annual amount of expenditure on the renewal or replacement of existing assets
restricted cash and securities	mean that component of a council's holdings of cash and securities for which the uses are restricted, wholly or partially, by regulations or other externally-imposed requirements
specific purpose payments	mean the tied grants made by Commonwealth or State governments to councils
status quo renewals capital expenditure	means the annual amount of expenditure (in addition to routine maintenance) that is necessary to keep an asset's service capacity at the same level as it was at the beginning of the year
unrestricted cash and securities	mean a council's total holdings of cash and securities less any restricted component

ABBREVIATIONS

AAS	Australian Accounting Standards
ABS	Australian Bureau of Statistics
capex	capital expenditure
CPI	consumer price index (as compiled by the ABS)
GFS	government finance statistics
KPIs	key performance indicators
NSW Inquiry	the independent inquiry into the financial sustainability of local government in NSW sponsored by the Local Government and Shires Associations of NSW that reported in May 2006
Roads Survey	the *Annual Report on Local Government Road Assets and Expenditure* prepared by WA Local Government Association
SA Inquiry	the independent inquiry into the financial sustainability of local government in SA sponsored by the Local Government Association of SA that reported in August 2005
WALGA	WA Local Government Association
WALGGC	WA Local Government Grants Commission
WDV	the written down value of an asset

1. THE CURRENT FINANCIAL POSITION OF WA COUNCILS

This chapter provides our assessment of the current financial position of local government in Western Australia based upon an analysis of council balance sheets.

1.1 INTRODUCTION

A council's *financial position* involves the state of its balance sheet, and so the relative level – and composition – of its assets and liabilities.

Assets are instruments or entities over which a council has ownership rights and from which economic benefits may be derived by holding them, or using them, over a period of time. Assets comprise:

- *financial assets*, being assets that are in the form of financial claims on other economic units, and comprise cash, securities and other interest-earning financial instruments; and
- *non-financial assets*, being all assets other than financial assets.

Liabilities are a council's obligations to provide economic value to other economic units, and include (but are not limited to) interest-bearing obligations.

Rather than a conventional examination of assets and liabilities, the chapter is based upon the re-arranging of balance sheet items into the following *uses* and *sources* of 'capital', where capital involves all the financial resources employed by a council, which by their nature could be employed elsewhere in the economy:

TABLE 1-1: KEY USES AND SOURCES OF CAPITAL

Uses of Capital	Sources of Capital
Non-financial assets	Net financial liabilities (or 'debt' broadly defined)
Working capital	Net worth (or ratepayer 'equity')
Restricted cash and securities	

1.2 USES OF CAPITAL

1.2.1 DEFINITION AND MEASUREMENT ISSUES

KEY CONCEPTS

Capital is invested by councils in the ownership of non-financial assets and certain financial assets.

Non-financial assets are all assets other than assets that are in the form of financial claims on other economic units, and include operating assets[1] and community assets[2] (which in turn are composed of infrastructure assets[3] and heritage assets[4]). They also include inventories (including materials, supplies, work in progress, finished goods and goods for resale) and valuables (e.g. works of art).

The only *financial assets* that we consider to be uses of capital are:

- restricted cash and securities; and
- working capital.

Restricted cash and securities are those holdings of such financial assets whose use is restricted, wholly or partially, by regulations or other externally-imposed requirements. While many councils also use internally restricted cash and securities to indicate the provisions made for the future, the discretionary nature of this practice warrants focus just on externally restricted cash and securities.

We measure a council's working capital as its total receivables less total payables.

BASIS FOR VALUATION OF NON-FINANCIAL ASSETS

As explained in Appendix A, for all our assessments in this report, we have relied upon financial data reported by councils prepared in accordance with the accounting and financial reporting requirements embodied in the WA *Local Government Act* and the Australian Accounting Standards.[5, 6]

As discussed in more detail in chapter 3 below, the published values of WA councils' non-financial assets are heavily dependent on the method of valuation used to compile each council's financial accounts. These assets are valued in accordance with requirements specified in accounting standards, which generally do not require universal or continual application of current values.

Under Australian Accounting Standards, each class of non-financial assets must be measured on either:

- the *cost* basis, effectively historical cost; or

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[1] Assets utilised in producing and delivering goods and services to the public, including land and buildings for administrative purposes, motor vehicles, EDP equipment, plant, electrical fixtures and fittings, staff amenities, equipment and telephones and data communication systems.

[2] Assets acquired or constructed by councils to meet the needs of the communities they serve and not the direct needs of the councils themselves, in contrast to operating assets which are those used directly by councils to provide services.

[3] All non-current assets that comprise the public facilities that provide essential services and enhance the productive capacity of the economy; include roads, bridges, drains, footpaths, kerbing and guttering, pavements, sea-walls, levee banks and other major public works, parks and gardens and playing fields.

[4] Assets intended or required to be preserved for the duration of their physical lives because of their unique historical, cultural, geographical or environmental significance; include monuments, museum collections and historic buildings.

[5] The Australian Accounting Standard (AAS) 27, "Financial Reporting by Local Governments" has applied to councils in Western Australia since the early 1990s.

[6] In principle, the alternative involves use of financial data compiled in accordance with the concepts and classifications used by the Australian Bureau of Statistics (ABS). The ABS data adopts the Government Finance Statistics system, an internationally consistent format for presenting the financial transactions of governments. We have opted to focus on the AAS-based statements because:

- councils are familiar with this financial data; and
- the information is available on an up-to-date basis for all WA councils, and includes 2004-05.

There is substantial overlap between the principles, practices and measurement methods adopted by both the Generally Accepted Accounting Principles (GAAP) and Government Finance Statistics (GFS) frameworks. However, although accrual accounting principles are applied under GFS, some of the definition, recognition, measurement, classification and presentation principles and rules differ from GAAP.

- the *fair value* basis, under which revaluations are made with sufficient regularity to ensure that the carrying amount of each asset in the class does not differ materially from its fair value at the reporting date.

Only where non-financial assets are being measured at current prices will:

- the resultant depreciated asset values indicate the amount of capital currently employed by a council; and
- the annual depreciation expense indicate both the consumption of capital by that year's ratepayers and the amount of capital expenditure necessary during the year in order to restore the asset to the service potential apparent at the beginning of the year in question.

Consistent valuation of non-financial assets at current prices is unlikely to occur in council accounts. A mixture of valuations is therefore likely to be present in the published financial statements of WA councils.

Adjustment of the source data to a current value basis is generally feasible only where information is available, for each council, for each class of non-financial assets regarding:

- the average elapsed life of the assets; and
- the valuation methodology that has been applied to those assets.

Unlike the case for the NSW councils (for example), such information is not generally available for WA councils. Of necessity, therefore, analysis in this report is based upon asset values that often fall short of current values. This needs to be borne in mind at relevant points throughout our analysis.

MEASURING RESTRICTED CASH AND SECURITIES

The 'restricted' portion of each council's cash and securities is not generally disclosed in the published financial statements of WA councils, and it is not recorded in the WALGGC financial data base.

However, included in each council's annual financial return to the WALGGC is a split in interest received between reserve accounts and general funds. We have used the ratio between interest received on reserve accounts and total interest received as a proxy for the relative size of the restricted proportion of a council's cash and securities. If anything, this method seems likely to overstate the restricted portion as reserve accounts also reflect internal restrictions.

CHOICE OF DENOMINATOR

For the purposes of comparisons between years, and comparisons among different councils, it is necessary to express any dollar-value measure of a council's financial position in an appropriate *ratio form*. This involves the choice of a suitable denominator for such a ratio.

Rather than basing comparisons of the capital employed by WA councils on estimated resident population (sourced from the Australian Bureau of Statistics), we have chosen to make comparisons using the number of assessments (or rateable properties) in each WA council as the relevant denominator. The WALGGC annually collects information on the number of assessments made by each WA council.

1.2.2 LEVEL AND COMPOSITION OF CAPITAL EMPLOYED AT 30 JUNE 2005

In total, based upon published asset values, WA councils employ about $13 billion in capital. This is approximately ¼% of the nation's $5,000 billion capital base.

Table 1-2 indicates the composition of capital employed by WA councils as at 30 June 2005.

TABLE 1-2: LEVEL AND COMPOSITION OF CAPITAL EMPLOYED ALL WA COUNCILS, 30 JUNE 2005

	$M	%
Non-financial assets	12,347.6	96.6%
Working capital	2.8	0.0%
Restricted cash and securities	430.3	3.4%
Total capital employed	**12,780.7**	**100.0%**

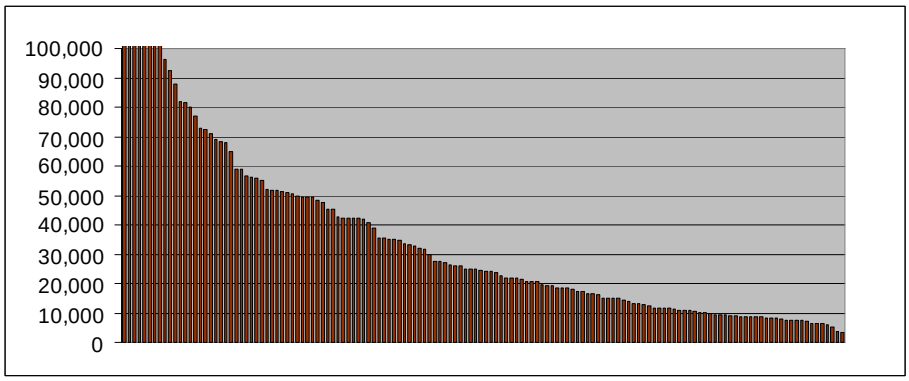
The overwhelming proportion of capital employed by WA councils is that invested in non-financial assets.

1.2.3 DIFFERENCES WITHIN THE SECTOR

The local government sector is the sum of individual councils rather than an entity of concern in itself.

Differences evident among WA councils in their average capital employed per assessment as at 30 June 2005 are shown in Chart 1-1, which portrays each council's capital employed per assessment ranked in descending order. This type of chart shows the extent of differences among individual councils without revealing the identity of particular councils.

CHART 1-1: AVERAGE CAPITAL EMPLOYED PER ASSESSMENT WA COUNCILS, 30 JUNE 2005



It is evident from Chart 1-1 that there is a wide disparity among WA councils in the average capital employed per assessment. This disparity may be due in part to differences in the method of asset valuation.

While the focus of this report is on the finances of local government as a whole and not on individual councils, the diversity among the WA councils is considerable. There are significant differences in size and population, road length and infrastructure, resources and skills base, and physical, social and cultural environments.

As explained further in Appendix B, we find it useful to distinguish:

- between metropolitan and regional councils, with regional councils in turn separated into those with and without large towns;
- based upon the relative growth rate of resident population, between above-average growth councils and declining councils; and
- based upon their operating expenditure, between the largest 25% of councils and the smallest 25% of councils.

Table 1-3 compares the average capital employed per assessment across council groupings.

TABLE 1-3: AVERAGE CAPITAL EMPLOYED PER ASSESSMENT BY TYPE OF COUNCIL, WA COUNCILS, 30 JUNE 2005

	no of councils	$
Metropolitan	29	10,017
Regional, with large towns	27	15,498
Regional, without large towns	86	34,431
Above-average growth	30	12,662
Declining population	71	26,265
Largest 25%	35	11,044
Smallest 25%	35	37,305
All WA Councils	**142**	**13,864**

Metropolitan councils generally employ less capital than their regional counterparts, no doubt due in part to the generally larger areas serviced by the roads network in non-metropolitan areas. More efficient councils are also expected to employ less capital than less efficient ones.

1.3 SOURCES OF CAPITAL

1.3.1 DEFINITION AND MEASUREMENT ISSUES

As in the private sector and elsewhere in the public sector, councils obtain their capital from two different sources, namely debt and equity.

Debt generally involves the financial obligations that a council has to other economic units aside from its ratepayers net of any financial obligations that these other economic units have to the council.

Equity is the capital which is contributed to a council by its ratepayers usually in the form of capital that is retained in a council rather than being returned to its ratepayers. Equity is measured by the amount of capital employed that is not sourced from debt.

MEASURING 'DEBT'

There are two main analytical measures of a council's indebtedness at the end of a particular financial year derivable from its balance sheet. These are:

- net debt, as measured by interest-bearing liabilities less unrestricted cash and securities; and
- net financial liabilities/(worth), as measured by net debt plus other net liabilities (namely provisions plus any other liabilities (less any other assets) that are not included in the measurement of either capital employed or net debt).

Net debt is traditionally favoured, being an indicator of the value of financial claims on a council by financial intermediaries less the council's financial claims on such financial intermediaries. However, there is an increasing acceptance that the net debt measure is limited by its narrow coverage of a council's financial obligations.

We consider the *net financial liabilities* measure to be the more comprehensive measure – for analytical purposes – of a council's reliance on debt (broadly defined). The net financial liabilities measure is the key analytical balance now being used for assessing the financial position of the Commonwealth and State governments in

Australia. The net financial liabilities of a council are all financial claims on a council by other sectors of the economy other than ratepayers (in the form not only of interest-bearing liabilities but of other liabilities) less the council's financial claims on these other sectors.

CHOICE OF DENOMINATOR

For the purposes of comparisons between years, and comparisons among different councils, we prefer to use total capital employed as the denominator for any net financial liabilities ratio. The resultant ratio is an indicator of a council's 'financial gearing'. As such, we have calculated a council's *financial gearing* by expressing its net financial liabilities position at a particular point in time as a percentage of the total capital it employs at that time.

DEBT BURDEN

For councils (as for corporations and other governments), there is no right or wrong level of financial gearing. It is more a question of the level of gearing that can be supported by a council's revenues and net cash flows.

Generally, a council's financial position is in a healthy state if its net financial liabilities are at levels where the servicing of such liabilities can be met comfortably from a council's annual income (i.e., by current ratepayers) at the existing rating effort.

Net interest expense is a measure of the annual balance between a council's interest expense and interest income. This measure provides an indication of the council's annual debt-servicing burden.

Associated with our practice of only netting off unrestricted (and not restricted) cash and securities for the purposes of calculating net financial liabilities and net debt, we have only used interest income on the unrestricted portion of total cash and securities for the purpose of calculating net interest expense. Total interest income has been split between its restricted and unrestricted amounts in proportion to our estimates of the restricted and unrestricted components of a council's cash and securities. We have classified interest earnings on the restricted portion of total cash and securities separately as a form of operating revenue.

We prefer to use the net interest ratio rather than the more traditional 'debt servicing ratio' that includes annual principal repayments as well as interest expense. Under modern treasury management practices (where the borrower is an entity in perpetuity), maturing debt is almost invariably rolled over such that debt principal repayments are financed out of new borrowing rather than operating revenue and a proportion of assets is always financed from borrowings. Under such practices, the inclusion of principal repayments in any debt burden indicator can be misleading. Only if *credit foncier* loans[7] are the norm (as they are in the household sector), and principal repayments as well as interest payments are met out of income, will there be a role for a debt servicing ratio that includes principal repayments.

1.3.2 LEVEL AND COMPOSITION OF SOURCES OF CAPITAL AT 30 JUNE 2005

By definition, sources of capital in total are identical to the uses of capital.

Table 1-4 indicates the composition of the sources of capital for WA councils.

[7] Loans that involve equal payments comprising interest payments and principal repayments.

TABLE 1-4: LEVEL AND COMPOSITION OF SOURCES OF CAPITAL ALL WA COUNCILS, 30 JUNE 2005

	$M	%
Net financial liabilities (or 'debt capital')	-22.6	-0.2%
Ratepayer equity (or 'equity capital')	12,803.2	100.2%
Total sources of capital	**12,780.7**	**100.0%**

Overwhelmingly, ratepayer equity is the principal source of capital employed by WA councils. As a general rule, debt capital is little used by councils.

1.3.3 NET FINANCIAL LIABILITIES AT 30 JUNE 2005

Based upon the most recent year's data, we have calculated the net financial liabilities of WA councils and their associated financial gearing.

Table 1-5 shows our calculation of the financial gearing of WA councils as at 30 June 2005.

TABLE 1-5: NET FINANCIAL LIABILITIES RATIO ALL WA COUNCILS, 30 JUNE 2005

Net debt[a] ($M)	-172.7
plus	
Other liabilities[b] ($M)	150.1
equals	
Net financial liabilities ($M)	**-22.6**
divided by	
Capital employed ($M)	12,780.7
equals	
Financial gearing (%)	**-0.2%**

[a] Total interest-bearing liabilities less unrestricted cash and securities
[b] Provisions plus other liabilities n.e.i. less other assets n.e.i.

On average, the financial gearing of WA councils at 30 June 2005 was just in negative territory, at -0.2% This implies that WA councils on average were net creditors, with their holdings of unrestricted cash and securities (essentially councils' cumulative lending to other sectors of the economy) exceeding council's total liabilities to these other sectors.

A useful benchmark is offered by the current levels of financial gearing observed within the general government sector of the WA State government. The equivalent data for that sector, and the resultant financial ratios, are summarised at Appendix C. Table 1-6 summarises the comparative levels of financial gearing as at 30 June 2005.

TABLE 1-6: NET FINANCIAL LIABILITIES RATIO WA STATE AND LOCAL SECTORS, 30 JUNE 2005

	%
WA councils	-0.2%
WA State government[a]	15.4%

[a] General government sector; Source: Appendix C

It is clear that the financial gearing of WA councils on average is substantially lower than the WA State government's. Across State governments, we generally observe target (and so benchmark) net financial liabilities ratios in the order of 20% for their general government sector.

State government borrowings involve a mix of interest-bearing liabilities and the liabilities arising from their *unfunded* superannuation schemes. These latter liabilities arise because State governments as employers in effect have been compulsorily borrowing from their employees each year the increase in the superannuation liability.

1.3.4 NET INTEREST RATIO IN 2004-05

Table 1-7 shows the calculation of the net interest expense of WA councils in total and their associated net interest ratios.

TABLE 1-7: NET INTEREST RATIO
ALL WA COUNCILS, 2004-05

Interest expense ($M)	17.1
less	
Interest income on unrestricted cash & securities ($M)	36.5
equals	
Net interest expense ($M)	**-19.4**
divided by	
Total revenue[a] ($M)	1,683.2
equals	
Net interest ratio (%)	**-1.2%**

[a] Before capital transfers, interest on unrestricted cash & securities and realised gains on asset sales.

On average, net interest expense is only a fraction – and a negative one at that – of operating revenue.

For local government, a useful benchmark is offered by the current net interest ratio observed within the WA State government sector. Table 1-8 summarises the comparative levels of net interest in 2004-05.

TABLE 1-8: NET INTEREST RATIO
WA STATE AND LOCAL SECTORS, 30 JUNE 2005

	%
WA councils	-1.2%
WA State government[a] [b]	2.2%

[a] General government sector; Source: Appendix C

[b] Includes nominal interest on unfunded superannuation liabilities

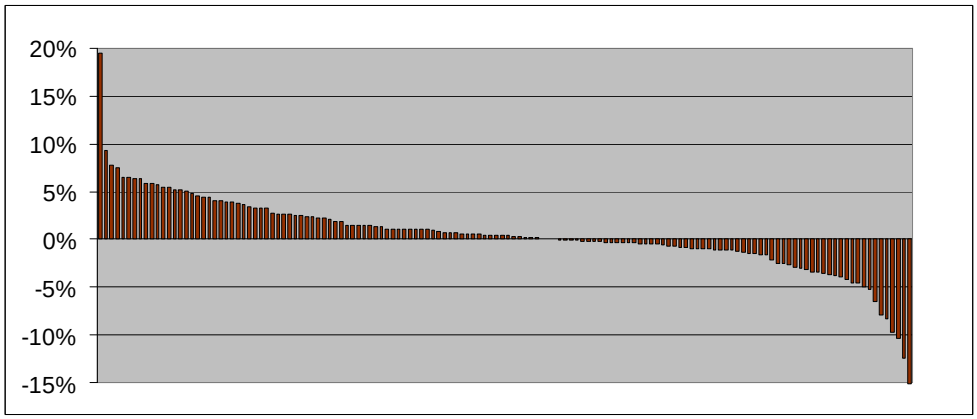
On average, WA councils have net interest ratios clearly below the State government's ratio.

1.3.5 DIFFERENCES WITHIN THE SECTOR

NET FINANCIAL LIABILITIES

Differences evident among WA councils in their financial gearing as at 30 June 2005 are shown in Chart 1-2, which portrays the financial gearing of each council ranked in descending order.

CHART 1-2: NET FINANCIAL LIABILITIES RATIO
WA COUNCILS, 30 JUNE 2005



Only 16 councils had net financial liabilities in excess of 5% of the capital they employed. 60 councils had negative ratios, and so were net creditors with their holdings of unrestricted cash and securities exceeding their total liabilities.

Table 1-9 compares the average financial gearing of councils across council groupings.

TABLE 1-9: NET FINANCIAL LIABILITIES RATIO, BY TYPE OF COUNCIL
WA COUNCILS, 30 JUNE 2005

	no of councils	%
Metropolitan	29	-1.6%
Regional, with large towns	27	2.3%
Regional, without large towns	86	0.3%
Above-average growth	30	0.3%
Declining population	71	0.6%
Largest 25%	35	-0.6%
Smallest 25%	35	1.0%
All WA Councils	**142**	**-0.2%**

Financial gearing is typically slightly higher for regional councils than for metropolitan councils. It is the metropolitan councils and the largest councils that are the main net creditors.

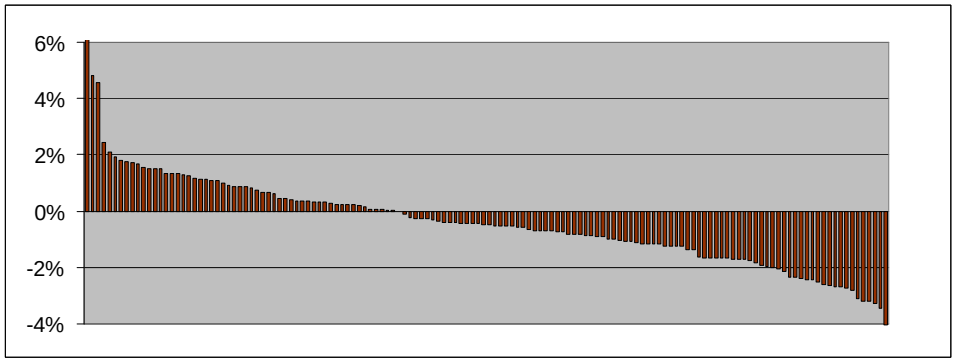
Contrary to expectations, there is little difference between the financial gearing of the faster growing councils and the declining ones. In addition, the financial gearing of the smallest councils is greater than that of the largest ones.

NET INTEREST RATIO

Reflecting the case for their financial gearing, there are significant differences among WA councils in their net interest ratios. At the same time, negative net interest expense can produce negative interest ratios, which are essentially meaningless. Where a council's net interest expense is negative, essentially it has no debt burden.

Differences evident among WA councils in their net interest ratios in 2004-05 are shown in Chart 1-3.

CHART 1-3: NET INTEREST RATIO
WA COUNCILS, 2004-05



Only 5 councils had net interest ratios above the benchmark represented by the State government's ratio. All other councils had net interest ratios below the State government's ratio.

Table 1-10 compares the net interest ratios of councils in each of the major groupings.

TABLE 1-10: NET INTEREST RATIO, BY TYPE OF COUNCIL
WA COUNCILS, 30 JUNE 2005

	no of councils	%
Metropolitan	29	-1.9%
Regional, with large towns	27	0.1%
Regional, without large towns	86	-0.1%
Above-average growth	30	-0.8%
Declining population	71	-0.4%
Largest 25%	35	-1.5%
Smallest 25%	35	0.1%
All WA Councils	**142**	**-1.2%**

Net interest is typically higher for regional councils than for metropolitan ones. On average, the smallest councils if anything tend to exhibit slightly higher net interest ratios (and so higher debt burdens) than the largest councils.

1.4 KEY CONCLUSIONS

From a ratepayer perspective, of interest is the extent to which a council's balance sheet is, in a financial sense:

- too highly geared, in which case pressure for rates increases (and/or spending cuts) may be evident; or
- too lowly geared, in which case rates may be too high (and the use of debt financing too low).

There is no evidence councils continue to suffer from any past over-reliance on borrowing. Accordingly, from this perspective, the balance sheets of WA councils are generally very strong.

We view our analysis as providing *prima facie* evidence that WA councils are under-using debt, with councils reluctant to borrow even when it may be prudent to do so.

2. THE CURRENT FINANCIAL PERFORMANCE OF WA COUNCILS

This chapter provides our assessment of the current financial performance of local government in Western Australia based upon an analysis of council operating statements.

2.1 INTRODUCTION

A council's *annual financial performance* involves the state of its annual operating statement, and especially the annual surpluses or deficits between its:

- annual operating revenue on the one hand and annual expenses on the other; and
- total annual revenue on the one hand and total annual spending, capital as well as operating, on the other.

2.2 OPERATING SURPLUS/(DEFICIT)

2.2.1 DEFINITION AND MEASUREMENT ISSUES

We regard the *operating surplus/(deficit)* measure to be the key analytical balance in relation to a council's annual *operating* financial performance. Only the operating surplus analytical balance distinguishes between current and capital spending, and between the financing of current spending through rates (the 'tax price' paid by current ratepayers) and the financing of capital spending through debt (to be serviced by tax prices paid by future ratepayers).

As a general principle, operating expenses plus a fair measure of annual depreciation represent the spending on outputs the consumption of which give rise to benefits derived wholly in the current period. Capital spending results in benefits beyond the current period. When the operating surplus appropriately measured is positive, rates revenue is more than sufficient to finance current operations. When the operating surplus is negative (indicating an operating *deficit*), rates revenue is insufficient to finance current operations.

Choices regarding the measurement of an operating surplus/(deficit) arise for two general reasons, namely the appropriate treatment of:

- capital grants and contributions ("capital transfers" for short); and
- changes in net worth due to external factors such as general price movements and the like.

For reasons set out in the next two sub-sections, our preferred measure of the *operating surplus/(deficit)* is as follows:

> revenues from ordinary activities before both capital transfers and any gains from the disposal of assets or the revaluation of assets
>
> *less*
>
> expenses from ordinary activities before any losses from the disposal of assets or the revaluation of assets.

When measured this way, an operating surplus indicates that costs incurred in the year in question are at least being met by today's ratepayers and not being transferred to tomorrow's ratepayers. An operating deficit indicates

the portion of costs incurred in the year in question that is being transferred to tomorrow's ratepayers and so is not being met – as ideally it should – by today's ratepayers.

OPERATING SURPLUS/(DEFICIT) BEFORE CAPITAL TRANSFERS

The format of the statement of financial performance under AAS27 is structured so as to disclose expenses from ordinary activities followed by revenues from ordinary activities. This format allows for the disclosure of an operating result both before and after recognition of grants and contributions provided for capital purposes. [8]

The choice of analytical balance depends very much on the goals of the analysis being undertaken.

When measured *after* capital transfers (i.e., capital grants and contributions), the operating surplus/(deficit) is equal to the change in a council's net worth. All transactions that increase a council's net worth are classified as revenue. In general, transactions that increase net worth result from current operations. Capital transfers are the exception. When negative, the operating surplus/(deficit) measured *after* capital transfers indicates that a shortfall has been incurred on current operations and that it has been necessary to liquidate assets, incur liabilities or increase equity in order to finance those operations. [9]

When measured *before* capital transfers, the operating surplus/(deficit) is equivalent to the 'net saving' indicator in the national accounts. When negative, it indicates the portion of a council's costs incurred in the year in question that is being transferred to tomorrow's ratepayers rather than being met by today's ratepayers.

We prefer the operating surplus/(deficit) measured *before* capital transfers as a measure of the sustainability of government operations because of its relevance to the analysis of inter-generational equity.

OPERATING SURPLUS/(DEFICIT) BEFORE REVALUATIONS

Like the ABS, but not recognised in the Australian Accounting Standards, we also prefer to focus – for the purposes of assessing a council's annual operating financial performance – on the component of the operating surplus/(deficit) that is due to 'transactions' as opposed to 'other flows': [10]

- 'transaction flows' represent changes to balance sheet items that come about as a result of mutually-agreed interactions between economic units; e.g., the sale of a good or service by one unit and its purchase by another; [11] and

---

[8] Extraordinary items aside, the operating statement presentation required of councils under Australian Accounting Standards reports two operating surplus-related measures, as follows:

net gain from the disposal and/or revaluation of assets
plus other revenues from ordinary activities before capital amounts
less expenses from ordinary activities
equals surplus/(deficit) *before capital amounts*
plus grants and contributions provided for capital purposes
equals surplus/(deficit) *after capital amounts*.

[9] For example, in concept, the ABS uses the operating surplus/(deficit) measured *after* capital revenue, which it terms the net operating surplus. As explained in the *Australian System of Government Finance Statistics: Concepts, Sources and Methods*, Chapter 2: Australian GFS framework, October 2003, in the GFS system, capital transfers received are classified as revenue because they increase net worth and they are often indistinguishable from current transfers in their effect on government operations. The ABS's net operating surplus is equal in concept to the national accounting balance of net saving plus capital transfers.

[10] This distinction is fundamental to the International Monetary Fund's GFS framework that is adopted by the ABS.

[11] Transactions also include items such as depreciation in the recognition that an economic unit is both the owner of a fixed asset and the consumer of the services provided by that asset. Also, despite their compulsory nature, taxes are considered to be transactions as they are deemed to occur by mutual agreement between the government and the taxpayer.

- 'other flows' represent changes to balance sheet items that do not result from a transaction. For example, revaluations represent changes that arise from price movements, including exchange rate and interest rate movements.

We prefer to focus on the operating surplus/(deficit) that is due to 'transactions' in order to measure the sustainability of government operations, not only because it excludes the effects of transactions that are infrequent or unusual, but also because transaction flows reflect policy and managerial decisions while the other flows arise more passively – often without active decision-making.[12]

The other flows component of the operating surplus/(deficit) (such as net gain or loss from the sale of assets that appear as revenue or expense from ordinary activities under the accounting standards) cannot be attributed directly to council policies, as councils do not directly control the gains and losses resulting from changes in price levels. Only the component of the operating surplus/(deficit) due to transactions can be attributed directly to council policies, since councils have control over their transactions.

ANNUAL DEPRECIATION EXPENSE

Whether a council's operating surplus/(deficit) is measured appropriately depends crucially on the adequacy of the annual depreciation charge used. Councils have significant discretion in choosing the depreciation method appropriate to the nature of their assets and their expected use taking into account the expected physical wear and tear of the asset, its obsolescence and legal or other limits on the use of the asset.

Depreciation expense measures the consumption or loss of service potential or future economic benefits of non-financial assets with limited useful lives. The recognition of depreciation is essential both:

- to represent the proper cost of operations and the extent to which that cost has been recovered from the current generation of ratepayers through operating revenue; and
- to ensure that the service potential or future economic benefits of depreciable assets is not overstated.

As many of the activities of councils are capital intensive, there is significant investment in the non-financial assets that comprise the infrastructure necessary to support local government services, particularly in relation to the roads network. The depreciation charge is therefore a major expense item for councils.

Annual depreciation expense is a function of both the value or cost of an asset and the length of the asset's life. The length of asset life assumed for this purpose is essential to the proper measurement of annual depreciation expense. Table 2-1 compares the average asset lives for WA councils with those calculated for NSW and SA councils in their respective Inquiries.[13]

[12] Because of their focus on entity performance (including financial position and investing and financing decisions), accounting standards do not make the GFS distinction between transactions and other economic flows. Accounting standards consider that entity management is responsible for the effective management of all resources, including transactions and movements in market values. Accounting standards therefore include:

- in operating revenue, any gains on the disposal of non-financial assets and on the revaluation of all types of assets; and
- in operating expenses, any losses on the disposal of non-financial assets and on the revaluation of all types of assets.

[13] The independent inquiry into the financial sustainability of local government in NSW ("NSW Inquiry") reported in May 2006. The independent inquiry into the financial sustainability of local government in SA ("SA Inquiry") reported in August 2005.

TABLE 2-1: AVERAGE ASSET LIVES[a]

	Metropolitan councils	Regional and country councils	All
WA councils[b]	37	44	40
NSW councils[c]	52	49	50
SA councils[c]	45	22	34

[a] Calculated by dividing the gross value of council assets (i.e., prior to deducting accumulated depreciation) by the amount of annual depreciation expense

[b] 2004-05 (based upon a sample of councils)

[c] 2000-01

It is evident that the asset lives used for depreciation purposes can and do vary across States and among councils. However, we are unable to assess whether the asset lives used by WA councils are misstated, and have therefore opted not to make any adjustment in this area. The asset lives generally used by WA councils fall between the relatively long values used by NSW councils and the generally short values used by SA councils.

Also of concern is any reporting of annual depreciation expense on an *historical cost* basis. Annual depreciation based on historical cost will understate both the consumption of capital by that year's ratepayers and the amount of capital expenditure necessary during the year in order to restore the council's non-financial assets to the service potential apparent at the beginning of the year in question. Where asset values and so depreciation are based on historical cost, the calculated operating surplus/(deficit) will be systematically overstated and of little value for the purposes of any analysis of inter-generational equity.

For the purposes of this report, we have used the annual depreciation data published by WA councils. As this data is included in audited accounts that are then relied upon by external stakeholders, we see no choice other than to assess a council's financial performance based upon the published depreciation data until such time as councils generate more appropriate and comparable data.

TREATMENT OF 'CAPITAL' GRANTS FROM OTHER GOVERNMENTS

Where a council has discretion to spend grants labelled as 'capital' grants by the donor government on either maintenance or capital investment, the ABS prefers to treat such grants as operating grants and subsidies. However, continuing differences between councils in the accounting treatment of grants received from other spheres of government have been evident in other jurisdictions. We have no reason to believe that this is not also the case for WA councils.

The local roads grant component of Financial Assistance Grants from the Commonwealth and the 'Roads to Recovery' grants from the Commonwealth are the main cases in point. In this regard, the WALGGC financial data base only distinguishes between local roads grants, State capital grants and other Commonwealth capital grants.

We have dealt with this issue by:

- for the local roads grant component of Financial Assistance Grants (which may or may not be counted as capital grants by councils), treating these grants all as operating grants;
- for 'Roads to Recovery' grants from the Commonwealth, apportioning these grants between 'operating' and 'capital' grants for each council in proportion to the maintenance and renewal component of roads expenditure as recorded in the WALGA's annual *Roads Survey* publication; and
- for all other grants labelled by councils as 'capital' grants received from other government, treating all these grants as capital grants.

OPERATING CONTRIBUTIONS

The operating and capital components of each council's revenue from 'contributions' are not generally distinguished in the published financial statements of WA councils, and are not recorded separately in the WALGGC financial data base.

Instead, we have treated the floor (or minimum) contribution observed for each council over the four years to 2004-05 as the on-going (and so operating) component, with the variable above-floor amount as the capital component. If anything, this approximation is likely to overstate the operating component of a council's contributions revenue, resulting in an overstatement of the council's operating surplus.

CHOICE OF DENOMINATORS

The choice of denominator for the operating surplus/(deficit) ratio lies between total rates revenue and total own-source revenue. We have chosen the latter given the role to be played in reducing any operating deficits by increased revenue-raising effort in the areas of user charges and other own-source revenue as well as by rates.

Where an operating deficit is apparent, the operating deficit to own-source revenue ratio indicates the percentage increase necessary on average in total own-source revenue collections if the operating deficit is to be eliminated.

By contrast, where an operating surplus is apparent, the operating surplus to own-source revenue ratio indicates the percentage decrease that would be possible in total own-source revenue collections were just an operating balance to be achieved.

We have therefore calculated a council's *operating surplus ratio* by expressing its annual operating surplus/(deficit) as a percentage of its annual own-source revenue (which excludes all grants from other governments as well as any net gain from asset disposals and revaluations).

2.2.2 OPERATING SURPLUS IN 2004-05

Table 2-2 shows our calculation of the operating surplus/(deficit) of WA councils and the associated operating surplus ratio.

TABLE 2-2: OPERATING SURPLUS RATIO
ALL WA COUNCILS, 2004-05

Operating revenue ($M)	1,702.5
less	
Operating expenses ($M)	1,335.8
less	
Net interest expense ($M)	-19.4
less	
Depreciation expense ($M)	450.3
equals	
Operating surplus/(deficit) ($M)	**-64.2**
divided by	
Own-source revenue ($M)	1,414.8
equals	
Operating surplus/(deficit) ratio (%)	**-4.5%**

On average, WA councils registered operating deficits in 2004-05 amounting to 4½% of their own-source revenue. By comparison, as shown in Table 2-3, the WA State government general government sector recorded an operating surplus in 2004-05 in excess of 10%.

TABLE 2-3: OPERATING SURPLUS RATIO
WA STATE AND LOCAL SECTORS, 30 JUNE 2005

WA councils	-4.5%
WA State government[a]	12.3%

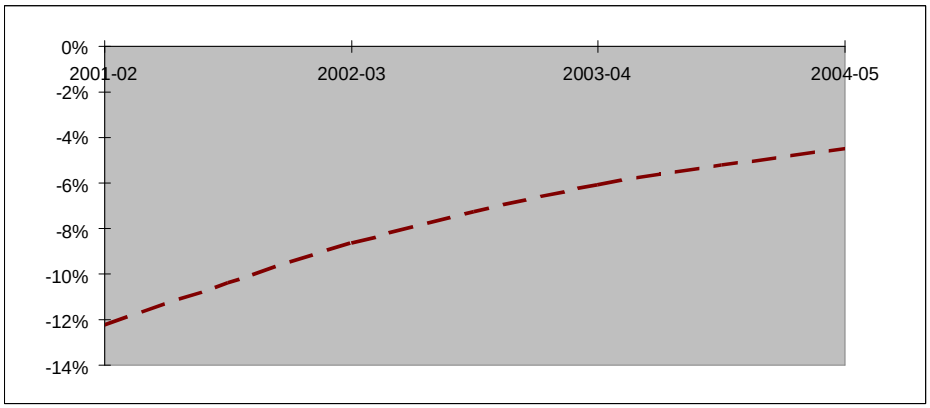
[a] General government sector. Source: Appendix C

A council's annual operating financial performance is sustainable if operating deficits are avoided over the medium- to long-term. At the same time, a council's operating surplus can be too high where either it is associated with current ratepayers being asked to bear an inequitable proportion of the cost of the council's future service potential or it is above a level that includes more than enough room to absorb unexpected financial risks or financial shocks. Hence, the benchmark for the operating surplus/(deficit) is around zero.

2.2.3 RECENT HISTORY

Chart 2-1 shows the recent movements evident in the operating surplus ratio of WA councils.

CHART 2-1: OPERATING SURPLUS RATIO
ALL WA COUNCILS, 2001-02 TO 2004-05



Note: a negative value indicates an operating deficit

Across all WA councils, the operating surplus has shown signs of improvement over recent years. The operating deficit ratio has halved between 2001-02 and 2004-05.

Table 2-4 shows the various sources of this reduction in councils' operating deficits. While operating expenses have increased in real-terms at an annual average by nearly 3%, rates revenue has increased by nearly 4% and non-rates own-source revenues by 9%. Operating grants from other governments have only barely kept pace with councils' no-policy-change costs (which we regard to be at about a nominal per-property percentage increase equal to around 1½ times the annual CPI increases).

Hence, the reduction in council operating deficits in recent years has been achieved by councils' own-source revenues increasing significantly faster than their operating costs. Of itself, this is symptomatic of the unsustainable nature of councils' current policies and cannot necessarily be relied upon going forward.

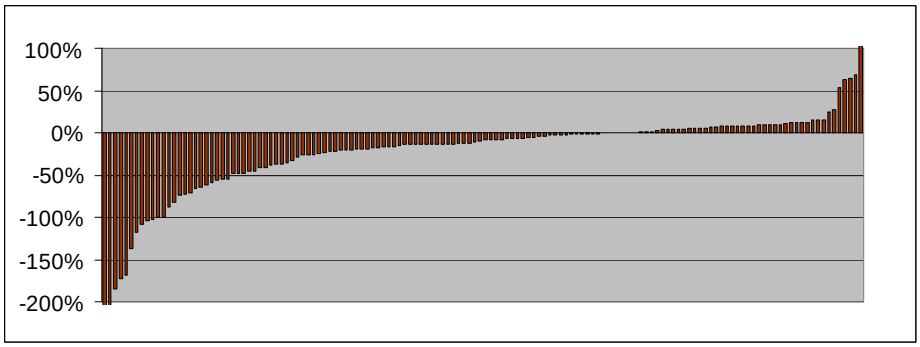
**TABLE 2-4: SOURCE OF OPERATING DEFICIT REDUCTION
ALL WA COUNCILS, 2001-02 TO 2004-05**

	avg annual real-terms per-property increases (%)	avg annual nominal per-property increase as % of avg annual CPI increase
Operating expenses	2.9%	212%
Own-source revenue	5.7%	325%
Rates revenue	3.8%	251%
Non-rates own-source revenues	9.0%	456%
Operating grants from other governments	1.1%	144%

2.2.4 DIFFERENCES WITHIN THE SECTOR

The differences evident among WA councils in their operating surplus ratios are shown in Chart 2-2.

**CHART 2-2: OPERATING SURPLUS RATIO
WA COUNCILS, 2004-05**



49 councils had positive operating surpluses, with 7 councils recording surpluses in excess of 20%. Of the councils showing operating deficits, their average deficit was the equivalent of 17.4% of their annual own-source revenue. 70 councils (or 49%) had operating deficits in excess of 10%.

Table 2-5 compares the average annual operating financial performance of councils in each council grouping.

**TABLE 2-5: OPERATING SURPLUS RATIO, BY TYPE OF COUNCIL
WA COUNCILS, 30 JUNE 2005**

	no of councils	%
Metropolitan	29	1.3%
Regional, with large towns	27	-12.0%
Regional, without large towns	86	-23.0%
Above-average growth	30	-3.3%
Declining population	71	-18.8%
Largest 25%	35	-1.2%
Smallest 25%	35	-15.0%
All WA Councils	**142**	**-4.5%**

Metropolitan councils on average recorded the slightest of operating surpluses. The regional councils on average recorded sizeable operating deficits.

2.3 NET BORROWING/(LENDING)

2.3.1 DEFINITION AND MEASUREMENT ISSUES

Net borrowing/(lending) is the key analytical balance in relation to the council's *overall* annual financial performance, encapsulating annual "capital" as well as 'operating' financial performance.

Net borrowing/(lending) is measured by annual transactions in liabilities less any annual transactions in relevant financial assets (in this case excluding restricted cash and securities). It measures the change in a council's net financial liabilities due to annual transactions (capital as well as operating). In an accounting context, it broadly corresponds with the annual change in net financial liabilities apart from the effect of any revaluations, and so indicates the extent to which a council is either utilising the financial resources generated by other sectors or putting financial resources at the disposal of other sectors in the economy.

When net borrowing is positive, the net increase in a council's total capital employed is greater than the annual increase in its ratepayer equity, and so involves an increase in the council's net financial liabilities. It indicates that a council has to incur liabilities and/or liquidate financial assets in order to finance asset acquisition and current operations.

Net lending involves the situation where the net increase in a council's total capital employed is less than the annual increase in its ratepayer equity, and so involves a decrease in the council's net financial liabilities. This is equivalent to negative net borrowing. When net lending occurs, the council has to purchase financial assets or repay liabilities in order to use surplus funds.

BORROWING INVOLVES MORE THAN AN INCREASE IN INTEREST-BEARING LIABILITIES

As we have defined it, net borrowing is more than the annual change in a council's gross debt levels. In the sense that we (and the ABS) use it, net borrowing is the annual change in net financial liabilities due to transactions. A council's net financial liabilities can increase during a year for reasons in addition to an increase in its gross debt levels: there can also be 'borrowing' from employees (by increased employee liabilities) and from future operations (by increased provisions), as well as draw downs or disposals of a range of financial assets.

The reason why the ABS and State governments all now prefer the accrual concept of net borrowing/(lending) over the cash concept of borrowing/lending is that a government's holdings of non-debt liabilities and financial assets each require as much management attention as does debt itself.

CHOICE OF DENOMINATORS

As our interest in annual net borrowing stems from the resultant increase in net financial liabilities, (opening) net financial liabilities are an obvious choice for denominator. The resultant ratio would indicate the percentage change in net financial liabilities associated with the observed annual net borrowing/lending amount.

However, whether a particular increase in net financial liabilities implies an increase or a decrease in a council's financial gearing depends upon whether or not the increase matches the associated net increase in capital employed. Therefore, the denominator we have chosen to use for the net borrowing/(lending) indicator is the annual net increase in capital employed, with the resultant ratio being akin to an external financing ratio.

We have therefore calculated a council's *net borrowing ratio* by expressing its annual net borrowing/(lending) as a percentage of the net annual increase in capital employed. [14]

2.3.2 NET BORROWING IN 2004-05

Table 2-6 shows the calculation of the net lending/(borrowing) of WA councils and the associated net borrowing ratio for each of the years 2001-02 to 2004-05.

TABLE 2-6: NET BORROWING RATIO
ALL WA COUNCILS, 2001-02 TO 2004-05

	2001-02	2002-03	2003-04	2004-05
Capital expenditure ($M)	510.0	561.5	566.7	699.0
plus				
Other additions to capital employed[a] ($M)	-9.2	-53.9	35.4	4.4
plus				
Assets donated ($M)	50.7	28.4	89.5	101.3
less				
Depreciation expense ($M)	376.1	415.5	419.6	450.3
less				
Disposals of non-financial assets (book value) ($M)	189.3	59.2	85.9	81.2
equals				
Net increase in capital employed ($M) (excluding revaluations)	**-14.0**	**61.3**	**186.1**	**273.3**
less				
Net increase in ratepayer equity (net worth) ($M)	64.5	133.6	190.8	265.8
comprising:				
Operating surplus/(deficit) ($M)	-136.7	-106.6	-80.0	-64.2
plus Capital transfer sources of increases in net worth ($M)	201.3	240.2	270.8	330.0
comprising:				
Capital grants from other governments ($M)	122.6	111.4	116.4	147.8
plus Capital contributions ($M)	34.4	12.0	26.5	55.5
plus Assets donated ($M)	50.7	28.4	89.5	101.3
plus Net gain on disposal of non-financial assets ($M)	-14.4	13.7	16.5	13.9
plus Other capital receipts ($M)	8.0	74.7	21.8	11.5
equals				
Net borrowing/(lending) ($M)	**-78.6**	**-72.3**	**-4.7**	**7.5**
divided by				
Net increase in capital employed ($M)	-14.0	61.3	186.1	273.3
equals				
Net borrowing ratio (%)	**-100.0%**[b]	**-117.9%**	**-2.5%**	**2.7%**

(a) Includes increased holdings of financial assets for working capital purposes and in the form of restricted cash and securities

(b) Constrained to –100% on account of the net decrease in capital employed

[14] Annual net decreases in total capital employed can produce negative ratios where a council in a net lender. To ensure comparability, where a council exhibits an annual net decrease in its capital employed, the calculated ratio is net borrowing/(lending) divided by the net decrease in total capital employed. A negative value for this ratio in these circumstances will correctly denote net lending. For simplicity, we have constrained net borrowing ratios to a minimum level for those years when net decreases in capital employed are evident, with this minimum level notionally set at -100%. Councils with net lending but positive net increases in capital employed will also have a negative calculated net borrowing ratio.

On average, WA councils undertook net borrowing in 2004-05 equal to not quite 3% of the net increase in capital employed. In previous years, WA councils were net lenders in aggregate.

A council's net borrowing can be too high if, over the planning period, it results in the council's net financial liabilities as a ratio of capital employed approaching or exceeding the targeted financial gearing. A council's net borrowing may be too low where, over the planning period, it results in the council's net financial liabilities as a ratio of capital employed falling well below the targeted ratio.

On this basis, where a council's financial gearing is around the level targeted, the benchmark net borrowing ratio is the same ratio as the financial gearing. On the other hand:

- where a council's financial gearing is well below the level targeted, the benchmark net borrowing ratio would be above the ratio equal to the targeted financial gearing ratio (for as long as financial gearing remains below the level targeted); and
- where a council's financial gearing is well above the level targeted, the benchmark net borrowing ratio would be below the ratio equal to the targeted financial gearing ratio (for as long as financial gearing remains above the level targeted).

Table 2-7 summarises the comparative levels of the net borrowing ratio during 2004-05 between the State and local government sectors in Western Australia.

TABLE 2-7: NET BORROWING RATIO
WA STATE AND LOCAL SECTORS, 30 JUNE 2005

WA councils	2.7%
WA State government[(a)]	-2.4%

[(a)] General government sector. Source: Appendix C

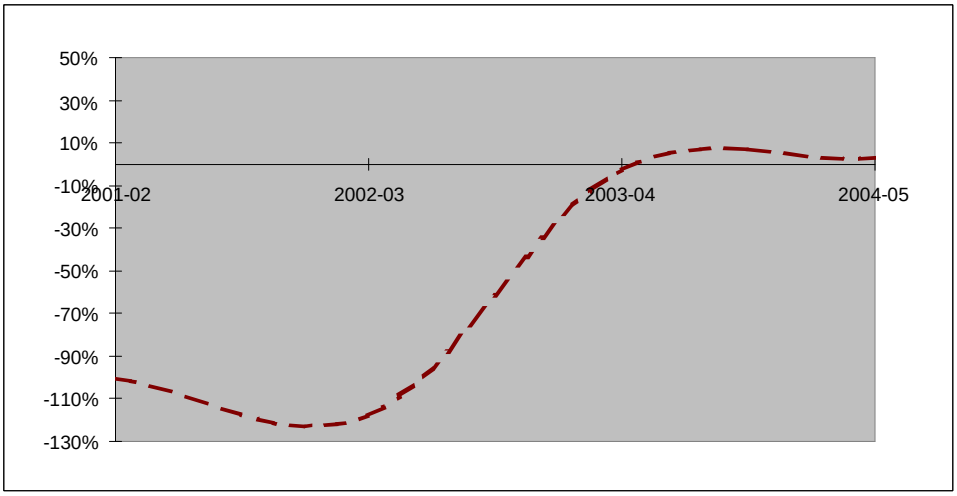
The WA State government ratio reveals more about that sector's target financial gearing (and the relationship currently between target and actual gearing) than it does about the net borrowing ratios targeted in the longer term, with the State government regarding its current financial gearing to be above targeted levels.

2.3.3 RECENT HISTORY

Chart 2-3 shows recent movements in the net borrowing/(lending) of WA councils.

This pattern is explained by underlying movements in the net increase in total capital employed and in that part of this net increase which is financed from ratepayer equity sources. As can be seen from an inspection of Table 2-6, a net borrowing requirement has only emerged in 2004-05 as a result of the trend increase in ratepayer equity apparent over recent years not keeping pace with a trend net increase in total capital employed.

CHART 2-3: NET BORROWING RATIO
ALL WA COUNCILS, 2001-02 TO 2004-05



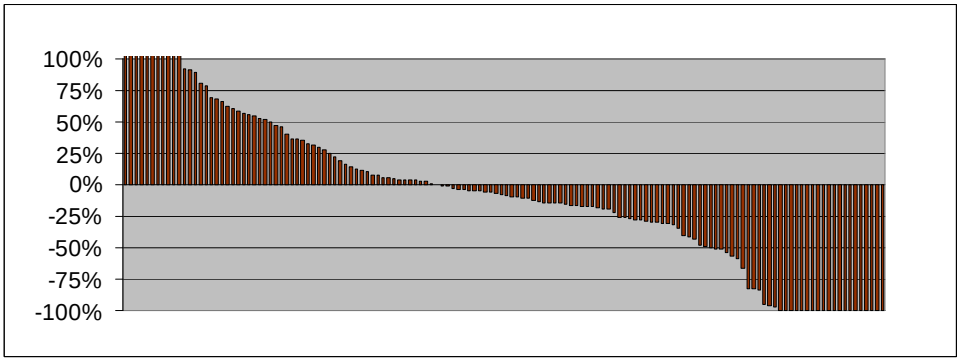
Note: a negative value indicates annual net lending

2.3.4 DIFFERENCES WITHIN THE SECTOR

There are significant differences among WA councils in their net borrowing ratios.

Differences evident among WA councils in their net borrowing/(lending) in 2004-05 are shown in Chart 2-4.

CHART 2-4: NET BORROWING RATIO
WA COUNCILS, 2004-05



59 councils (or just over 40%) had positive net borrowing ratios in 2004-05. The remainder were either net lenders or they were not in fact increasing their capital employed (in net terms).

Table 2-8 compares the average annual net borrowing ratios of councils in each of the council groupings.

Metropolitan councils recorded net borrowing ratios averaging nearly 10% in 2004-05, similar to the average ratio recorded by the above-average population growth councils. The largest net borrowers were the smallest councils. Regional councils without large towns and declining population on average were substantial net lenders in 2004-05.

**TABLE 2-8: NET BORROWING RATIOS, BY TYPE OF COUNCIL
WA COUNCILS, 30 JUNE 2005**

	no of councils	%
Metropolitan	29	9.7%
Regional, with large towns	27	2.7%
Regional, without large towns	86	-50.1%
Above-average growth	30	9.3%
Declining population	71	-53.1%
Largest 25%	35	8.8%
Smallest 25%	35	19.1%
All WA Councils	**142**	**2.7%**

2.4 KEY CONCLUSIONS

A council's annual operating financial performance is sustainable only if the council avoids both excessive borrowing and operating deficits over the medium- to long-term. Measured properly, operating deficits indicate the funding of a proportion of services consumed by current ratepayers being shifted – one way or another – onto future ratepayers.

Running operating deficits appears to be the norm in WA councils. Where operating deficits persist, indications are that rates revenue is insufficient to finance current operations. The reduction that has been evident in council operating deficits in recent years has been achieved only by councils' own-source revenues increasing at rates significantly greater than the increases in their operating costs. Of itself, this is symptomatic of the unsustainable nature of councils' current policies and cannot necessarily be relied upon going forward.

However, excessive borrowing is not the issue for WA councils. Rather than incurring debt in order to finance their annual operating deficits, most WA councils have instead been relying for some time on capital transfers (such as capital contributions, capital grants and the proceeds of asset sales) for this purpose. In effect, councils typically have been running surpluses on their capital accounts in order to fund deficits in their operating accounts.

Such capital surpluses are only possible by deferring capital spending that should be undertaken on existing and new infrastructure and for which purposes the collection of capital revenue (such as capital contributions and capital grants) can only be justified. Hence, instead of the usual net borrowing (and accumulated debt) consequences of operating deficits, an infrastructure spending backlog seems likely to have emerged for many WA councils. We turn to this issue in the next chapter.

3. INFRASTRUCTURE-RELATED FINANCIAL OBLIGATIONS OF WA COUNCILS

This chapter examines the financial requirements that arise on account of councils' stewardship of the non-financial assets on their balance sheet.

A raft of obligations comes with a council's non-financial assets.

In fact, besides examining the usual dimensions of a council's financial position and performance (as we have in chapters 1 and 2), also important is the analysis of a council's:

- annual performance with regard to the maintenance and renewal/replacement of existing assets; and
- the obligations associated with any cumulative backlog in the council's maintenance and renewals effort, which in effect is a 'liability' facing the council just as much as borrowings but one that does not show up on its balance sheet.

For this reason, conventional balance sheet and operating statement analysis alone is insufficient in the case of local government in Australia.

Both the NSW and SA Inquiries revealed that infrastructure presented a particular challenge facing local government. This chapter examines these issues in the WA context.

3.1 NATURE AND VALUE OF COUNCIL ASSETS

3.1.1 DEFINITION AND MEASUREMENT ISSUES

CLASSES OF ASSETS

The WALGGC financial data base contains information on the written down values (WDV) of council assets compiled from annual returns based upon each council's published annual financial statements but using a high level classification of assets. For the 2004-05 returns, this classification was a five-fold one: land, buildings, infrastructure, plant & equipment, and other. Unlike NSW and SA, there is no central repository of information on the more detailed composition of local government assets together with information on asset-related annual transactions (maintenance expense, depreciation expense, capital expenditure, and asset disposals) disaggregated on the same asset classification basis.

Information published in WA councils' annual financial statements is also limited because, unlike in NSW and SA, there are minimal accounting requirements for councils to group council assets into uniform classes and sub-categories.[15] This reduces both consistency and comparability in the asset data provided by WA councils

[15] For example, in NSW, councils are subject to 'Guidance on Asset Classifications', Appendix 6 in the *Local Government Asset Accounting Manual*, NSW Department of Local Government, Update No 4 July 1999.

themselves, which was evident from returns provided in a survey of councils we undertook for the purposes of this Inquiry.

The survey was sufficient, however, for us to split the WALGGC 'infrastructure assets' category into its roads and non-roads components, where:

- 'roads infrastructure' include both sealed and unsealed roads as well as ancillary assets such as bridges, culverts, drainage and footpaths; and
- 'other infrastructure' includes such items where applicable as: stormwater and drainage systems, parks and sporting fields, airports, caravan parks and livestock sales yards.

While returns to our survey were only received from about one-third of councils, we assessed this sample to be representative enough to use the information at the council grouping level. The results reported in this chapter are based upon the disaggregation of each council's total infrastructure assets applying either the splits reported by each council responding to the survey or, for councils that did not respond to the survey, the average splits reported by similar councils (i.e., those that reported in the council's grouping).

VALUATION OF ASSETS

Based upon the councils responding to our survey, about 30% of the published written down value of non-financial assets was valued on a current value basis (such as replacement cost or fair value), while the remaining 70% was valued at historical cost. Replacement cost valuation was only applied to infrastructure assets, but not consistently or uniformly.

We estimate that the written down value of roads infrastructure reported in council balance sheet as at 30 June 2005 was around 90% of the written down replacement cost of these assets as estimated in WALGA's 2004-05 *Roads Survey*.[16] This is a similar result to that for SA councils, but a much higher ratio than for NSW councils. On this basis, we decided not to apply the type of valuation adjustment we felt obliged to use in the NSW Inquiry.

This does not imply that the asset valuation approaches by WA councils are fully appropriate or consistent. Rather, it is our view that errors possible in any global valuation adjustment could be significant in the WA case relative to the relatively small valuation misstatement (likely to be in the 0% to 20% range for WA councils).

3.1.2 CURRENT SITUATION

Based upon the WALGGC financial data base, and the associated estimates we have made, WA councils are the custodians of over $12 billion of non-financial assets.

Table 3-1 shows the composition of the non-financial assets held by WA councils.

[16] The *Annual Report on Local Government Road Assets and Expenditure* prepared by WA Local Government Association. This survey uses estimates of replacement cost based on roads inventory data from Main Roads WA.

**TABLE 3-1: NON-FINANCIAL ASSETS
ALL WA COUNCILS, 30 JUNE 2005**

	$M	%
Land	625.7	5.1%
plus Buildings	1,903.1	15.4%
plus Roads infrastructure	7,518.1	60.9%
plus Other infrastructure	1,758.6	14.2%
plus Plant and equipment	413.0	3.3%
plus Other assets	129.1	1.0%
equals **Total non-financial assets**	**12,347.6**	**100%**

Roads infrastructure on average accounts for 60% of the total non-financial assets of WA councils. Buildings and other infrastructure assets combined accounts for a further 30%.

3.1.3 DIFFERENCES WITHIN THE SECTOR

On average, each WA council held $87 million in non-financial assets at 30 June 2005.

Table 3-2 compares the average non-financial asset holdings of councils in each of the council groupings.

**TABLE 3-2: NON-FINANCIAL ASSETS, COUNCIL AVERAGE
BY TYPE OF COUNCIL, WA COUNCILS, 30 JUNE 2005**

	no of councils	$M
Metropolitan	29	206.3
Regional, with large towns	27	109.8
Regional, without large towns	86	39.5
Above-average growth	30	140.4
Declining population	71	51.4
Largest 25%	35	221.6
Smallest 25%	35	25.1
All WA Councils	**142**	**87.0**

Each council has a different combination of non-financial assets (and so infrastructure financing pressures).

Table 3-3 compares the broad composition of councils' holdings of non-financial assets in each of the council groupings.

TABLE 3-3: COMPOSITION OF NON-FINANCIAL ASSETS BY TYPE OF COUNCIL, WA COUNCILS, 30 JUNE 2005

	Land	Buildings	Roads Infrastr	Other Infrastr	Plant and equipment	Other assets	TOTAL
Metropolitan	9.4%	17.9%	49.0%	19.7%	2.7%	1.3%	100%
Regional, with large towns	1.2%	14.5%	64.8%	15.6%	3.2%	0.7%	100%
Regional, without large towns	0.9%	11.8%	78.4%	3.4%	4.7%	0.9%	100%
Above-average growth	6.2%	15.9%	58.2%	15.9%	2.8%	1.0%	100%
Declining population	0.9%	11.9%	74.0%	8.2%	4.2%	0.9%	100%
Largest 25%	7.2%	17.1%	52.2%	19.5%	2.8%	1.1%	100%
Smallest 25%	0.9%	8.7%	79.5%	3.9%	6.0%	1.1%	100%
All WA Councils	**5.1%**	**15.4%**	**60.9%**	**14.2%**	**3.3%**	**1.0%**	**100%**

An example of the differences among councils is the substantial variation in roads assets between metropolitan and regional councils. Regional councils often encompass large areas of land with substantial roads networks. Many regional councils also have ageing infrastructure, and coupled with small population subsequently have a small rating base from which to fund maintenance and renewal. In contrast, most metropolitan councils have a lesser roads infrastructure to maintain and denser concentrations of people.

3.2 ASSET-RELATED EXPENDITURE

Asset-related spending can take various forms, although in practice these are rarely distinguished in council accounts.

3.2.1 MAINTENANCE EXPENSE VERSUS CAPITAL EXPENDITURE

Maintenance expenditure is spending on an existing asset which is periodically or regularly required as part of the anticipated schedule of works to ensure that the asset achieves its economic life or period of service between renewal. Maintenance expenditure:

- does not increase the asset's service potential or life;
- is essential to ensure the safe and effective operation of the asset during its period of service;
- may be planned or unplanned;
- is expensed; and
- includes associated labour costs as well as costs of materials and contractors.

Maintenance expenditure can include:

- annual routine maintenance; and
- the *rehabilitation* of assets that have prematurely degraded because they were not routinely maintained in the past.

By contrast, *capital expenditure* is any expenditure on non-financial assets that increases the service potential of the asset in question, and which should therefore be added to the asset's value.

The *Annual Report on Local Government Road Assets and Expenditure* prepared by WA Local Government Association ("Roads Survey") is a comprehensive assessment of local government roads assets and expenditure

in Western Australia. The *Roads Survey* provides important asset-related information in the WA context that was not available to the NSW and SA Inquiries.

The *Roads Survey* classifies roads expenditure by WA councils into maintenance expenditure and various forms of capital expenditure. Table 3-4 provides this split reported for the 2004-05 year.

TABLE 3-4: CLASSIFICATION OF ROADS EXPENDITURE ALL WA COUNCILS, 2004-05

	$M	%
Maintenance expense	148.1	37.9%
Capital expenditure	243.0	62.1%
Total	**391.1**	**100.0%**

3.2.2 UPGRADE/EXTENSION VERSUS REHABILITATION/RENEWAL

UPGRADE CAPITAL EXPENDITURE

Upgrade capital expenditure ("upgrade capex") involves expenditure on an existing asset which enhances that asset so as to provide a level of service that is greater or increases the life of the asset beyond that which it had originally. As this expenditure increases the asset's service potential or life beyond its original level, it is capitalised not expensed.

EXPANSION CAPITAL EXPENDITURE

Expansion capital expenditure ("expansion capex") involves expenditure on extending the boundaries or coverage of an existing asset network, at the same standard currently enjoyed by existing users, to a new group of users. Such expenditure is capitalised.

RENEWALS CAPITAL EXPENDITURE

Renewals capital expenditure ("renewals capex") involves expenditure on an existing asset which returns the service potential or the life of the asset to its original level. This can involve an asset being periodically renewed to reinstate its service potential or being replaced at the end of its economic life. As it reinstates existing service potential, it has no impact on revenue, but may reduce future operating and maintenance expenditure if completed at the optimum time. Such expenditure is capitalised.

Some assets get renewed constantly while other assets get periodically replaced. Different assets attract different practice. If capital spending is aggregated across a large group of assets, the renewal/replacement distinction is largely irrelevant. Hence, in the sense we use the term in this report, 'renewals' includes replacement.

ROADS SURVEY

The *Roads Survey* classifies each council's roads capital expenditure into renewal capex, upgrade capex and expansion capex.

Table 3-5 provides this split reported at the aggregate level for the 2004-05 year.

TABLE 3-5: COMPONENTS OF ROADS CAPITAL EXPENDITURE ALL WA COUNCILS, 2004-05

	$M	%
Renewals capex	114.4	47.1%
Upgrade capex	103.3	42.5%
Expansion capex	25.3	10.4%
Total	**243.0**	**100.0%**

As to non-roads assets, (with the exception of land which by its nature is not renewed or replaced) we have estimated the renewals capex on these assets for each council by adopting the same estimation method as we used for the NSW Inquiry (based upon a comparison of reported depreciation expenses and capital funding amounts)[17] but only with respect to non-roads assets.

Table 3-6 compares our estimates of the level and composition of total capital expenditure, for each of the council groupings.

TABLE 3-6: COMPOSITION OF TOTAL CAPITAL EXPENDITURE BY TYPE OF COUNCIL, WA COUNCILS, 2004-05

	Renewals capex			Upgrade/expansion capex			TOTAL CAPEX
	Roads	Other	Total	Roads	Other	Total	
Metropolitan	55.9	110.8	166.7	56.5	171.1	227.5	394.3
Regional, with large towns	24.0	47.7	71.8	33.2	33.5	66.6	138.4
Regional, without large towns	34.8	69.6	104.4	38.9	23.1	62.0	166.4
Above-average growth	26.3	71.0	97.3	50.9	115.1	166.0	263.2
Declining population	33.7	63.5	97.2	33.6	18.9	52.5	149.7
Largest 25%	69.9	136.5	206.4	76.2	192.7	268.9	475.3
Smallest 25%	11.9	20.0	31.9	11.3	0.8	12.1	44.0
All WA Councils	**114.7**	**228.1**	**342.8**	**128.5**	**227.6**	**356.2**	**699.0**

3.3 ANNUAL RENEWALS DEFICIT

3.3.1 DEFINITION AND MEASUREMENT ISSUES

We consider the *net acquisition of non-financial assets for renewal/replacement purposes* to be the analytical balance appropriate with regard to the annual financial performance of councils on the renewal or replacement of existing assets. It is measured by the difference between: [18]

- the actual capital expenditure on the renewal or replacement of non-financial assets undertaken in a particular year; and

[17] The methodology was briefly explained in Access Economics, *Local Government Finances in New South Wales: An Assessment*, Appendix G.

[18] By contrast, the *net acquisition of non-financial assets for upgrading/expansion purposes* is the analytical balance relevant to the annual financial performance of councils regarding capital transactions on the upgrading and expansion of services provided by a council's non-financial assets. It is measured by the difference between annual capital expenditure on non-financial assets for upgrading/expansion purposes on the payments side and the sum of annual proceeds from disposals, capital grants, capital contributions and all other capital revenue on the receipts side.

- the amount of capital expenditure that would have kept the service capacity of those assets at the same level as at the beginning of the year ("status quo renewals capex").

Positive annual net acquisition of non-financial assets for renewal/replacement purposes involves a situation where actual capital expenditure on the renewal or replacement of these assets exceeds the status quo renewals capex on those assets, with this portion of the renewal/replacement of such assets relieving future ratepayers of the responsibility for renewing or replacing such assets.

Negative annual net acquisition of non-financial assets for renewal/replacement purposes involves a situation where capital expenditure on the renewal or replacement of these assets falls short of the status quo renewals capex on those assets, with responsibility for this portion of the renewal/replacement of such assets effectively being shifted onto future ratepayers.

The *Roads Survey* includes a comparison, for each council, between the council's actual expenditure on the preservation of existing roads and the amount required to maintain council roads at their present condition. In particular, it reports a concept similar to the net acquisition of non-financial assets for renewal/replacement purposes for roads expenditure only, namely the shortfall between preservation needs and expenditure ("preservation shortfall"). This concept is measured by the difference between:

- the estimated cost (both maintenance and capital) of maintaining existing roads at their current condition (termed the *status quo cost*); and
- the actual expenditure on the maintenance and renewal of those roads undertaken in a particular year.

Compared with the net acquisition of non-financial assets for renewal/replacement purposes, the preservation shortfall provided for each council in the *Roads Survey* is measured in the negative and encompasses maintenance expense as well as renewals capex.

Table 3-7 shows the calculation of the preservation shortfall between 1994-95 and 2004-05.

TABLE 3-7: LOCAL GOVERNMENT ROADS: PRESERVATION SHORTFALL ALL WA COUNCILS, 1994-95 AND 2004-05

	Status quo cost (or required) roads expenditure ($M)	less Actual expenditure on preservation of existing roads[a] ($M)	equals **Shortfall between preservation needs and expenditure** ($M)
1994-95	234.0	172.0	**62.0**
1995-96	248.0	189.0	**59.0**
1996-97	254.0	186.0	**68.0**
1997-98	269.2	194.5	**74.7**
1998-99	271.0	204.4	**66.6**
1999-00	283.7	214.4	**69.3**
2000-01	293.1	218.6	**74.5**
2001-02	307.0	256.7	**50.3**
2002-03	324.8	251.7	**73.1**
2003-04	332.6	251.7	**80.9**
2004-05[b]	354.7	262.4	**92.3**

(a) includes council expenditure on flood damage

(b) provisional estimates, subject to revision

As the 2003-04 *Roads Survey* argued:

> *…the shortfall between preservation needs and expenditure has remained within the $65 million to $75 million range since 1998-99, except in 2001-02, when it fell to $50.3 million. This reduction was due to the introduction of the Roads to Recovery program. … That the shortfall has now increased above this range is a matter of concern. (p.10)*

The *Roads Survey* also establishes that expenditure on upgrading and expansion has grown faster than expenditure on maintenance and renewal over the last five years as shown in Table 3-8.

TABLE 3-8: EXPENDITURE ON MAINTENANCE, RENEWAL, UPGRADING AND CAPITAL EXPANSION, ALL WA COUNCILS, 2004-05

	1999-00 $M	2004-05 $M	Change %
Maintenance and renewal of existing roads	223.9	262.4	+17.2%
Upgrading and expansion of the roads network	99.7	128.6	+29.0%
Total expenditure	**323.6**	**391.0**	**+20.8%**

In the absence of estimates of councils' non-roads maintenance expenses, we prefer to focus just on renewals capex. However, unlike the cases for the NSW and SA Inquiries, the *Roads Survey* enables us to use direct estimates of the renewals capex component of status quo expenditure on existing assets rather than rely on reported depreciation expense as a proxy for this amount.

We have estimated the renewals capex component of the roads' status quo cost (which includes both maintenance and renewals expenditure) for each council by assuming that the ratio of actual to status quo costs is the same for both the maintenance and renewals components. Likewise, we have estimated the renewals capex component for the other (i.e., non-roads) assets for each council by assuming that the ratio of actual to status quo costs is the same for other infrastructure assets and for buildings as for roads infrastructure assets but equal to unity (i.e., one) for all other assets.

Table 3-9 compares our estimates of status quo renewals capex for each of the council groupings.

TABLE 3-9: ESTIMATES OF STATUS QUO RENEWALS CAPEX BY TYPE OF COUNCIL, WA COUNCILS, 2004-05

	Roads	Other	Total
Metropolitan	61.9	123.8	185.7
Regional, with large towns	30.2	64.6	94.8
Regional, without large towns	53.5	119.4	172.9
Above-average growth	33.7	92.1	125.8
Declining population	49.7	109.2	158.9
Largest 25%	81.0	160.8	241.8
Smallest 25%	17.6	32.6	50.2
All WA Councils	**145.6**	**307.8**	**453.4**

3.3.2 ESTIMATED RENEWALS DEFICIT IN 2004-05

Table 3-10 shows the calculation of the estimated net acquisition of non-financial assets for renewal/replacement purposes of WA councils.

TABLE 3-10: NET ACQUISITION OF NON-FINANCIAL ASSETS FOR RENEWAL/REPLACEMENT PURPOSES, ALL WA COUNCILS, 2004-05

	Roads	Total
Actual renewals capex ($M)	114.7	342.8
less		
Status quo renewals capex ($M)	145.6	453.4
equals		
Net acquisition of non-financial assets for renewal/replacement purposes ($M)	**-30.9**	**-110.6**
memo item:		
Actual-to-status quo renewals ratio (%)	75%	76%

On average, we estimate that the annual capital expenditure of WA councils on the renewal or replacement of all existing non-financial assets fell short of the status quo renewals capex amount for those assets by $110 million in 2004-05. Persistent shortfalls in capital expenditure on the renewal or replacement of existing assets involve shifting part of current ratepayers' share of the funding of infrastructure renewal or replacement onto future ratepayers.

The actual-to-status quo renewals ratios imply that councils spent 75% or so of the amounts required to maintain their roads in particular and all their non-financial assets in general at their current condition.

The associated actual-to-status quo renewal ratio for total non-financial assets of 76% falls between the estimates for NSW councils (70%) and for SA councils (90%) made earlier for these State's respective Inquiries.

As the 2003-04 *Roads Survey* pointed out:

> *The amount spent on renewal [for roads in WA] raises an important issue. Councils spent $103.4 million on asset renewal in 2003-04. This represents slightly less than 1% of the Current Replacement Value of the State's road infrastructure. This is less than half the 2% that road infrastructure wears out a year. This imbalance will become more critical as more of the roads built in the road building boom of the 1960s and 1970s reach the end of their useful life.*

For completeness, Table 3-11 shows the calculation of the estimated surplus/(deficit) maintenance of WA councils.

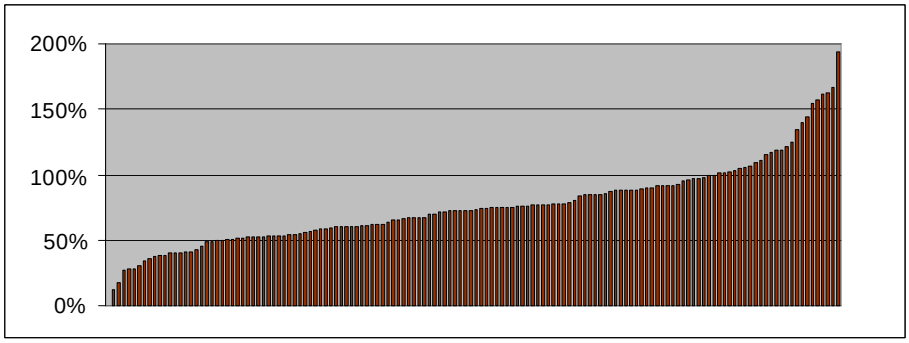
TABLE 3-11: SURPLUS/(DEFICIT) MAINTENANCE ALL WA COUNCILS, 2004-05

	Roads	Total
Actual maintenance ($M)	148.1	n.a.
less		
Status quo maintenance ($M)	198.1	n.a.
equals		
Surplus/(deficit) maintenance ($M)	**-50.1**	**n.a.**
memo item:		
Actual-to-status quo maintenance (%)	75%	n.a.

3.3.3 DIFFERENCES WITHIN THE SECTOR

This aggregate picture conceals importance differences between councils. The differences evident among WA councils in their actual-to-status quo renewals ratios for all non-financial assets are shown in Chart 3-1.

**CHART 3-1: ACTUAL-TO-STATUS QUO RENEWALS RATIO
ALL NON-FINANCIAL ASSETS, WA COUNCILS, 2004-05**



Only 26 councils (or close to 18%) are estimated to have had actual-to-status quo renewals ratios in excess of 100% in 2004-05. The remainder spent less than the amounts required to maintain all their non-financial assets at their current condition in 2004-05.

Table 3-12 compares the average actual-to-status quo renewals ratios of councils in each of the council groupings.

**TABLE 3-12: ACTUAL-TO-STATUS QUO RENEWALS RATIO
ALL NON-FINANCIAL ASSETS, BY TYPE OF COUNCIL
WA COUNCILS, 30 JUNE 2005**

	no of councils	%
Metropolitan	29	89.8%
Regional, with large towns	27	75.7%
Regional, without large towns	86	60.4%
Above-average growth	30	77.3%
Declining population	71	61.2%
Largest 25%	35	85.4%
Smallest 25%	35	63.6%
All WA Councils	**142**	**75.6%**

The renewals performance varies widely between councils. The average actual-to-status quo renewals ratio for metropolitan councils is better than for regional councils. The faster growing and largest councils display better actual-to-status quo renewals ratios on average than declining population and smallest councils.

3.3.4 QUALIFICATIONS

We have relied upon estimates of status quo costs for roads assets, and extrapolated the results across other types of infrastructure assets. As the 2003-04 *Roads Survey* noted:

> *Estimating status quo cost is difficult because it requires data on road age and condition, for which little data is available. Progress is being made in increasing the reliability of the estimates by obtaining data from councils that have undertaken road condition assessments. However, data on road condition is still inadequate, so it would be prudent to regard the estimates … in this report as indicative rather than definitive. (p.7)*

In future, councils should put increased effort into directly measuring (and reporting) their own status quo costs and their annual renewals performance.

Ideally, what is required is an estimate of the total expenditure that would need to have been spent on the assets in place during each year in question so that services would have been provided at satisfactory levels in terms of risk and safety, quality and function. This may include both maintenance costs/expenses and renewal capital expenditure. Council assessors will usually base the determination of a 'satisfactory' standard for asset related services on engineering estimates or analysis. Analysis should also be developed to base 'satisfactory' also on community outcomes such as level of service, life cycle, functionality, risk and safety. While 'satisfactory' condition can only be determined by a council, guidance should be available to ensure as much consistency and comparability as possible in the resulting estimates.

3.4 INFRASTRUCTURE BACKLOG

3.4.1 DEFINITION

A single year's negative net acquisition of non-financial assets for renewal/replacement purposes may reflect lumpiness in renewal/replacement activity. Of more significance is a series of years in which such negative net acquisitions are observed. The accumulation of past negative net acquisition over a period of time will indicate what can be termed an *infrastructure renewal/replacement backlog*.

An *infrastructure maintenance backlog* is also possible, where assets have prematurely degraded because they have not been not routinely maintained. This is sometimes called 'backlog maintenance', and gives rise to the need for the eventual rehabilitation of assets.

Our use of the term 'infrastructure backlog' covers both backlog forms.

3.4.2 ESTIMATED BACKLOG AT 30 JUNE 2005

The only source of information available of the possible infrastructure backlogs facing WA councils is that with respect to local government roads provided by the *Roads Survey*.

The *Roads Survey* uses estimates of both the replacement value and the written down value for all local government roads, where:

- replacement value is the current cost of replacing the roads assets; and
- written down value is the current value after allowing for accumulated depreciation.

The difference between replacement value and written down value represents the amount of an asset's service potential that has been consumed. The *Roads Survey* uses estimates of replacement cost based on roads inventory data from Main Roads WA.

Table 3-13 compares the 2004-05 *Roads Survey*'s estimates of the total replacement value and written down value of WA's local government roads assets.

For 2004-05, the written down value of WA council roads was estimated to be $8.4 billion, which is 65% of the estimated replacement value of $12.9 billion.

The *Roads Survey* reports that asset managers at WA Main Roads believe that this percentage should be about 75% for a well managed roads network, indicating that the condition of local government roads is below the level required by good roads management practice.

TABLE 3-13: ROADS ASSET VALUES ALL WA COUNCILS, 2004-05

	Replacement value ($B)	Written down value ($B)	%
1999-00	10.40	6.87	66.1%
2002-03	11.96	7.73	64.6%
2003-04	12.25	7.92	64.7%
2004-05	12.93	8.37	64.7%

We have used this 75% target ratio as a basis for putting a figure on the roads' infrastructure backlog, as illustrated in Table 3-14.

TABLE 3-14: ROADS ASSET VALUES ALL WA COUNCILS, 2004-05

	Target written down value ($B)	Actual written down value ($B)	Backlog ($B)	% of actual written down value
1999-00	7.80	6.87	0.93	13.5%
2002-03	8.97	7.73	1.24	16.0%
2003-04	9.19	7.92	1.27	16.0%
2004-05	9.69	8.37	1.32	15.8%

In view of the earlier estimates of the annual renewals deficiency (for roads of $30 million) and the annual maintenance deficiency (for roads of $50 million), this implies that the $1.3 billion backlog involves about 18 year's worth of the current annual deficiencies. The 11 year's worth of annual deficiencies shown on Table 3-7 above sum to around $850 million in present value terms.

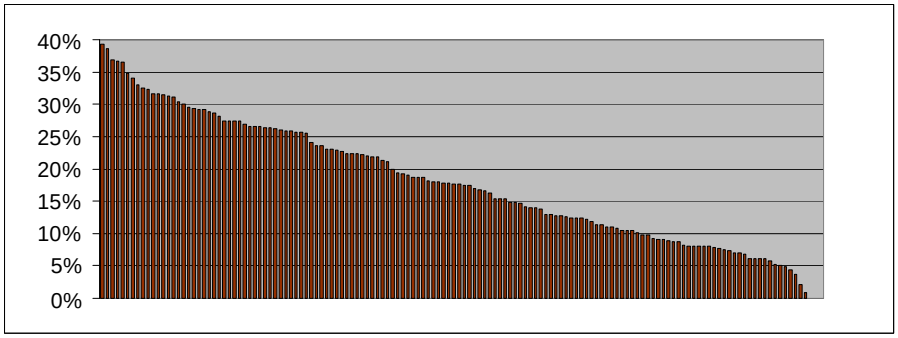
If a similar backlog was evident for all other (non-roads) infrastructure assets and for buildings (with our assumption being that backlogs do not accrue for other assets, and land does not depreciate), then the overall backlog could be in the order of $2 billion. However, we prefer to put the total backlog for WA councils closer to $1¼ billion, on the basis that renewals deficiencies are likely to be larger for the long-lived assets such as roads. This is about 14% of the total value of council non-financial assets in WA, which compares with the 10% or so for the finding of a $6.3 billion backlog made for the NSW Inquiry.[19]

3.4.3 DIFFERENCES WITHIN THE SECTOR

The differences evident among WA councils in their estimated infrastructure backlogs as a percentage of the total written down values of their non-financial assets are shown in Chart 3-2.

[19] NSW Inquiry (2006), p.24. These figures are not strictly comparable, as regional councils in NSW are responsible for water and sewerage assets.

**CHART 3-2: INFRASTRUCTURE BACKLOGS RATIO
WA COUNCILS, 2004-05**



108 councils (or close to 75%) are estimated to have infrastructure backlogs in excess of 10% of the written down value of their total non-financial assets at 30 June 2005.

Table 3-15 compares the average estimated infrastructure backlog of councils in each of the council groupings.

**TABLE 3-15: INFRASTRUCTURE BACKLOGS RATIOS
BY TYPE OF COUNCIL, WA COUNCILS, 30 JUNE 2005**

	no of councils	%
Metropolitan	29	5.8%
Regional, with large towns	27	22.2%
Regional, without large towns	86	20.6%
Above-average growth	30	11.1%
Declining population	71	21.6%
Largest 25%	35	9.6%
Smallest 25%	35	19.4%
All WA Councils	**142**	**13.8%**

The infrastructure backlog varies widely between councils. As was the case for the annual renewals effort, the infrastructure backlog ratios for metropolitan councils are lower than for regional councils. The faster growing and largest councils display smaller backlogs on average than declining population and smallest councils.

3.4.4 QUALIFICATIONS

The *Roads Survey* notes that it would be prudent to regard its council-by-council estimates of written down value as indicative rather than definitive. Once again, it should be incumbent upon councils to put increased effort into directly measuring (and reporting) estimates of their own infrastructure backlogs.

The *Roads Survey* backlog measure of infrastructure condition is *retrospective* – reflecting the 'catch up' needed to get infrastructure up to acceptable condition today. It does not take account of new infrastructure needs generated by a growing and shifting population, changing profile, likely changes to building and construction standards or rising community expectations and demands. Ideally, what is required is an estimate of the average annual maintenance costs/expense and renewals capital expenditure needed in future years. Such estimated expenditure would be annualised, and expressed in current dollar values. This backlog measure of infrastructure condition would be *prospective*.

3.5 WHAT IS CAUSING RENEWALS DEFICITS AND INFRASTRUCTURE BACKLOGS?

The *Roads Survey* has put forward a number of possible explanations for the renewals deficits and infrastructure backlogs being experienced by many WA councils. These include:

> *"…[council] policy decisions …which put increased priority on upgrading and expansion at the expense of preservation"*
>
> *"Some State Road Project grants are allocated specifically for upgrading and expansion of the road network. As Local Government has to contribute a third of the cost of these projects, some of its own funds are being diverted to upgrading and expansion of the road network."*
>
> *"…most councils do not have sufficient funds to meet their road preservation needs."*
>
> *"…The Roads to Recovery Program should have reduced the gap between preservation needs and available funds, but with the reduction in State funds, this has not occurred."*

We consider the causes to be not quite so clear cut.

Rather than redirecting capital funds to the financing of upgrading and expansion capex, our view is that councils instead are redirecting such funds to finance their operating deficits so as to avoid the usual borrowing consequences of these operating deficits. This is compounded by councils' aversion to using annual borrowing to fund their upgrade/expansion capital expenditure requirements.

The NSW Inquiry came to a similar conclusion:

> *Reductions in capital spending (both renewals and upgrade/expansions) may be a common means of balancing budgets. In fact, compelling evidence has been presented to the Inquiry that Councils' operating deficits are funded largely by running surpluses on their capital accounts rather than resorting to borrowing. This means capital contributions, capital grants and proceeds of asset sales are used mainly to prop up operating costs rather than to finance capital renewals and upgrade/expansions. (NSW Inquiry (2006), p.282)*

As is evident in Table 3-16, the operating deficits of WA councils are being financed in the main by capital surpluses (i.e., where capital expenditure levels fall short of the sum total of capital revenue).

TABLE 3-16: DETERMINANTS OF ANNUAL NET BORROWING ALL WA COUNCILS, 2001-02 TO 2004-05

	2001-02	2002-03	2003-04	2004-05
Net acquisition of new and upgraded assets	-135.6	-92.1	13.2	53.9
plus				
Net acquisition of existing non-financial assets	-71.4	-86.8	-97.9	-110.6
equals				
Capital deficit/(surplus)	**-207.0**	**-178.9**	**-84.7**	**-56.7**
less				
Operating surplus/(deficit)	-136.7	-106.6	-80.0	-64.2
equals				
Net borrowing/(lending)	**-70.3**	**-72.3**	**-4.7**	**7.5**

Source: Appendix D

We acknowledge that there are two contrary arguments worth brief consideration. These are that:

- some grants from other governments which we have treated as capital revenue are really meant to fund maintenance and not capital expenditure; and
- the annual depreciation expense reported by WA councils is overstated.

If correct, both arguments would question whether WA councils really have the operating deficits we have suggested, and whether capital surpluses are as high as indicated.

ARE SOME CAPITAL GRANTS MEANT TO FUND MAINTENANCE NOT CAPEX?

The first view is that some 'capital' grants from other governments are intended to fund maintenance rather than capital expenditure, and therefore are intended as substitutes for rates revenue rather than for annual borrowing.

As pointed out in chapter 2, we have treated all of the local roads grant component of Financial Assistance Grants and a proportion of the 'Roads to Recovery' grants from the Commonwealth as operating grants, but have treated all other grants labelled by councils as 'capital' grants from other government as capital grants.

It may be that a proportion of these other 'capital' grants should also be treated as operating grants to the extent that their purpose is to fund routine maintenance or maintenance backlogs. However, such grants also play a role in funding renewals capex and renewals backlogs. Therefore, the treatment of all these grants as capital grants would tend to overstate councils' operating deficits. However, the information necessary to apportion these grants between 'capital' and 'operating' components is not currently available. Offsetting this is our treatment of local roads grants entirely as operating grants, as these grants too are likely to include amounts intended to finance renewals (and upgrade/expansion) capital expenditure and so be a substitute for council borrowings rather than council rates.

We are therefore satisfied that any overstatement of capital grants is unlikely to give rise to any significant misstatement of the capital surpluses (and operating deficits) being run by WA councils.

IS DEPRECIATION EXPENSE TOO HIGH?

The second view is that annual depreciation expense is being overstated by councils. This would result in us overstating council capital surpluses (and operating deficits).

Accrual accounting and the requirement to account for depreciation were introduced so that councils could focus on the cost of depreciation and the quantum of funds required to renew/replace ageing non-financial assets. Despite the availability of accounting standards, the depreciation assessment remains a subjective process reliant on the interpretation of council assessors.

As discussed in chapter 1, the asset lives typically used by WA councils do not appear to be at the high end in comparison with those typically used in other States.

Besides, annual depreciation expense is more likely to be understated to the extent that its calculation is based on asset values that are understated by the continued use of historical cost (rather than current cost) asset valuations.

Nevertheless, an asset's annual rate of financial depreciation can differ from its annual rate of physical degradation. In fact, for a single asset, straight-line accounting depreciation is likely to overstate the desired amount of annual renewals capex in the early life of the asset (and understate the status quo renewals capex likely in the later life of the asset). For a single asset, the annual accounting depreciation expense is only likely, by chance, to be equal to the status quo renewals capex on that asset.

However, when many assets are aggregated together (encompassing a wide range of remaining asset lives), and the larger the organisation under review and the longer it has been in operation, the less significant may be the difference between total accounting depreciation for an organisation and the total status quo renewals capex. Hence, whenever the analysis is in relation to asset registers in total (where remaining asset lives vary considerably), the tendency of accounting depreciation to over- and under-estimate the status quo renewals

capex is increasing likely to be cancelled out as the organisations under consideration get bigger and/or the longer they have been in operation.

However, a gap between the status quo renewals capex and recorded depreciation would not of itself be an indicator that annual depreciation expenses are being misstated. Depreciation is the financial representation of the consumption of the asset over its useful life. Depreciation is commonly standardised by accountants to a fixed percentage rate that assumes the value of the asset declines by a straight line to nil by its life end. Depreciation is not a measure of the required maintenance and renewals expenditure on an asset in any given year. Nor does it reflect the actual deterioration pattern of an asset as monitored by an engineer. A common characteristic of infrastructure assets in that it takes approximately 50% of the useful life before the first 10% of wear indicators become visible.[20]

The reason why accountants depict assets as depreciating by an equal percentage each year is to prompt asset owners to set enough money aside for their eventual renewal. If councils were to use an engineers' asset degradation path for funding assets, they would not get around to depreciating them and thereby setting aside money for their replacement until they showed real wear and tear. By then it would be necessary to fund most of the renewals cost in a short time span.

AVERSION TO BORROWING SEEMS TO BE THE MAIN CAUSE

Neither of the above two arguments take into account the fact that the operating deficits currently being recorded by WA councils may understate the long-term position because of the annual maintenance shortfalls revealed in the *Roads Survey*, which could be in the order of $50 million. We have not made any adjustment for these shortfalls, in part in recognition that there may be offsetting considerations (including in the classification of capital grants and in the measurement of depreciation).

In sum, we are confident that – if anything – our estimates of WA councils' operating deficits are on the conservative side, and that the same is true for our estimates of the annual capital surpluses that have been run by councils in recent years.

For this reason, we are convinced that, rather than incurring debt in order to finance their annual operating deficits, WA councils – like their NSW and SA counterparts – have been relying for some time instead on capital revenue (such as capital contributions, capital grants and the proceeds of asset sales) for this purpose.

Such capital surpluses are only possible by deferring capital spending that should be undertaken on existing and new infrastructure and for which purposes the collection of capital revenue (such as capital contributions and capital grants) can only be justified. Hence, instead of the usual net borrowing (and accumulated debt) consequences of operating deficits, infrastructure backlogs have emerged for many WA councils.

3.6 KEY CONCLUSIONS

Council non-financial assets – particularly their infrastructure assets – are not being maintained or renewed to appropriate standards. Council have been responding to budgetary stress in particular by postponing expenditure on maintenance and asset renewal/replacement. This has induced an ongoing annual asset renewals gap and an infrastructure backlog. Making matters worse is the fact that major components of council infrastructure are expected to reach the end of their usable lives in coming decades.

Some of the revenue from capital grants, contributions and asset sales proceeds freed up as a consequence are being used by councils to cover operating deficits instead of the purposes for which these funds were intended.

[20] NSW Inquiry (2006), p.129.

Councils should be increasingly dedicating their revenues from capital grants, contributions and asset sales proceeds to capital purposes.

Moreover, the long-run decline in council's reliance on borrowing needs to be reversed. External borrowing can be an appropriate financing source in the right circumstances, namely when it is used to fund the acquisition of new non-financial assets or the upgrading of existing assets (as distinct from funding routine maintenance and the renewal of existing infrastructure assets which both should be funded out of internal cash flows). Use of borrowing to finance upgrade/expansion capex would then free up internally-generated funds which should be devoted to financing renewals capex.

Any limits on borrowing for the purpose of acquiring new infrastructure assets within the local government sector should be set – based upon expert advice and generally-accepted standards of prudence – by reference to a council's long-term financial capacity to service debt rather than an anti-debt mindset.

4. THE FINANCIAL CAPACITY OF WA COUNCILS

This chapter provides our assessment of the financial capacity of local government in Western Australia.

A council's *financial capacity* involves the funding (both operating and capital) that can be mobilised through its revenue-raising and financing policies.

A council's financial capacity involves more that the funding currently being mobilised by its existing revenue-raising and financing policies. For the purposes of this report, we take a council's financial capacity to also include the extent of any additional funding that could be mobilised were the council to increase its revenue-raising and financing efforts to levels commensurate with those displayed by higher-effort councils.

The analysis of financial statements alone (as in chapter 2) will fail to take account of any additional financial capacity available to a council.

The focus of this chapter is on all those revenue items that increase a council's net worth. As such, the financing that increases a council's net financial liabilities is outside the scope of this chapter.

Furthermore, this chapter focuses on a council's *own-source* revenue items. Hence, this chapter does not explore in any detail the funding that is sourced from the other tiers of government.

4.1 INTRODUCTION

Table 4-1 summarises the sources of operating revenue available to WA councils in 2004-05.

TABLE 4-1: OPERATING REVENUE WA COUNCILS, 2004-05

	$M	%	%
Rates revenue	869.7	61.5%	
plus Fees and charges	517.9	36.6%	
plus Investment income	27.2	1.9%	
equals **Own-source operating revenue**	**1,414.8**	**100.0%**	**83.1%**
plus Operating grants from the Commonwealth	221.1		13.0%
plus Operating grants from the State government	66.5		3.9%
equals **Total operating revenue**	**1,702.5**		**100.0%**

Clearly, for own-source operating revenue, rates revenue and fees and charges together are the most important components, on average accounting for nearly 98% of the own-source operating revenue of WA councils.

Table 4-2 summarises the sources of capital transfers available to WA councils in 2004-05.

TABLE 4-2: CAPITAL TRANSFERS WA COUNCILS, 2004-05

	$M	%	%
Developer charges[(a)]	156.8	86.0%	
plus Net gain on disposal of non-financial assets	13.9	7.7%	
plus Other capital receipts	11.5	6.3%	
equals **Own-source capital transfers**	**182.2**	**100.0%**	**55.2%**
plus Capital grants from other governments	147.8		44.8%
equals **Total capital transfers**	**330.0**		**100.0%**

(a) Comprises both (cash) capital contributions and (non-cash) asset donations

For own-source capital revenue, developer charges account for 86% of own-source capital transfers of WA councils.

4.2 RATES REVENUE

4.2.1 BACKGROUND

WA councils' rates powers and constraints are set out in the *Local Government Act 1995* (Part 6 Financial management, Division 6 Rates and service charges), and associated Regulations.

Under section 6.28 of the Act, it is the Minister for Local Government who determines the method of valuation of land to be used by a local government as the basis for a rate, with subsection (2) providing that:

> *In determining the method of valuation of land to be used by a local government the Minister is to have regard to the general principle that the basis for a rate on any land is to be —*
>
> *(a) where the land is used predominantly for rural purposes, the unimproved value [UV] of the land; and*
>
> *(b) where the land is used predominantly for non-rural purposes, the gross rental value [GRV] of the land.*

Under the Act, councils only have the power to set a rate which is expressed as a rate in the dollar of relevant value of rateable land within its district. Section 6.32 provides that a general rate on rateable land within a council's district:

- may be imposed either uniformly or differentially;
- may involve a specified area rate on rateable land within a portion of its district for the purpose of meeting the cost of the provision by it of a specific work, service or facility if the local government considers that the ratepayers or residents within that area; and
- may involve a minimum payment which is greater than the general rate which would otherwise be payable on that land.

Under Regulation 39 (Rating information) of the *Local Government (Financial Management) Regulations 1996*, a council's annual financial report is to include:

- for each rate: the rate in the dollar, whether the basis for the rate was the UV or GRV basis, any applicable minimum rate, the number of properties to which the rate was applied, the total rateable values of the properties, and the amount of revenue from the rate (including any interim rates and back rates);
- additionally, for each differential general rate, the characteristics which formed the basis for the imposition of the rate; and
- additionally, for each specified area rate, the purpose of the rate and a brief description identifying the area within which the rate was imposed.

The WALGGC collates this information in its financial data base, and we have had access to that source of data.

4.2.2 ASSESSING THE RATING SYSTEM

We consider that the local government rating system generally meets the criteria of administrative simplicity and efficiency, and – if administered carefully – is vertically and horizontally equitable.[21]

For a rating (taxing) system to be efficient, collection costs (administration, enforcement and taxpayer compliance costs) should be low. The present rating system is administratively cost-efficient, in that the tax base (land) is not mobile and stays broadly the same in physical and usage terms from one year to the next. Changes in ownership are notified to councils.

An efficient tax system is also one for which the costs arising from 'distortions' to consumption and production are low. Taxation of property values is generally considered non-distortionary and therefore efficient because the taxation of land does not affect the total supply of land. Moreover, a tax on land value has little effect on the amount of housing consumed or produced. It follows that taxes on land value have only minor efficiency (distortionary) effects.

Overall, the rates base can be viewed as an equitable base for taxation. It provides councils with a reasonable capacity to produce fair outcomes, where rates are related partly to services (the minimum rate) and partly to capacity to pay (the *ad valorem* rate on property values). In addition, because the tax base (land) is immobile and easily identified, tax cannot be evaded.

Fairness in a property-based taxation system is nevertheless a particular challenge where property values rise inconsistently across different areas. In fact, managing the impact of uneven movements in property valuations on the distribution of rates has been the particular challenge facing local government in the last few years. Evidence suggests that many councils were not prepared for the extent of uneven property valuation movements, and struggled to catch up with this development.

There is also a need for councils to protect their revenue base. The current system of concessions and rebates impinges on the integrity of the rating system.

A final question is whether the rating system meets the revenue adequacy criteria, whereby a council has access to the means to fund all services that may be reasonably demanded. This is the general subject of this report. For now, it is sufficient to observe that, overall, rates revenue is predictable and stable and allows for a fairly high level of local financial autonomy. The ability of councils to raise revenue depends on local political will, local household income, and any constraints that the State government may impose. Generally, the rates base is not itself a constraint on council revenue and most councils do not need new forms of taxes to survive.

[21] Vertical equity means that those with a greater capacity to pay should bear a bigger share of the tax burden. Horizontal equity means that households with a similar capacity to pay should pay approximately the same rates.

4.2.3 MEASURING RELATIVE RATING EFFORT

While council rates are expressed as a rate in the dollar of the relevant value of rateable land, we do not consider movements in this rate to be a useful indicator of a council's taxing effort over time.

From time to time, property values can increase significantly, as they have in recent years. At constant rates in the dollar, this would boost council revenue quite significantly. However, councils can and do adjust the rate in the dollar to offset changes in market values caused by the property cycle in order to meet required revenue targets. In this way, councils do not automatically reap windfall revenue from rising property values. Each year, councils are obliged to decide how much they each require from rates revenue to deliver infrastructure requirements and service levels, and to set the annual rate in the dollar accordingly.

The revenue that can be raised from the rates base is actually constrained by disposable household income, not by property values. Whether or not an average household can pay $700 a year (or a low income household can typically pay $400 to $500 a year) depends on their income after Commonwealth taxes and transfers.

As income data is not generally available at the council level, we have opted to compare a council's annual rating effort over time (and across councils themselves) by comparing the rates revenue collected each year on a *per-property* (or per-assessment) basis. Information on average per-property rates revenue is generally available within WA (and across States).

Moreover, in WA, because rates revenue and the number of rateable assessments are broken down into residential, commercial, industrial, mining and farmland categories, it is possible to take into account any structural differences in council rates.

Table 4-3 shows the calculation of this per-property rates revenue indicator for 2004-05, the latest year for which actual data is available.

TABLE 4-3: DERIVATION OF AVERAGE PER-PROPERTY RATES REVENUE ALL WA COUNCILS, 2004-05

	Rates revenue collected ($M)	Number of assessments (000s)	Revenue per assessment ($)
Residential	538.4	776.7	$693.19
Commercial	147.5	31.1	$4,749.00
Industrial	55.5	20.5	$2,709.28
Mining	16.1	17.1	$940.40
Farmland	112.1	76.4	$1,467.11
Total	**869.7**	**921.9**	**$943.40**

In 2004-05, across all WA councils, rates revenue collected per property was $943. For residential properties, the per-property rates revenue collected in the year was $693.

For a particular year, these per-property rates revenue figures are suitable for comparative purposes (and are used as such in section 4.2.6 below).

However, in order to make useful comparisons over time, we have calculated the average annual nominal percentage increase in per-property rates revenue over the four years between 2000-01 and 2004-05, and compared it with the average annual percentage increase in the State's consumer price index (CPI) for those years. The CPI is both an indicator of ratepayer capacity to pay and related to council cost movements, with

recent experience suggesting that council costs generally increase at a rate that is half as much again (i.e., 150% of) annual CPI movements.

Table 4-4 shows the calculation of this indicator:

TABLE 4-4: RELATIVE RATING EFFORT
ALL WA COUNCILS, 2000-01 TO 2004-05

	Average annual percentage increase, 2000-01 to 2004-05:		Rates increase as % of CPI increase
	Per-property rates revenue	CPI	
Residential	6.2%	2.54%	243%
Commercial	5.2%	2.54%	206%
Industrial	4.7%	2.54%	185%
Mining	8.4%	2.54%	330%
Farmland	4.3%	2.54%	171%
Total	**5.4%**	**2.54%**	**213%**

On average, across all WA councils over the four years to 2004-05, per-property residential rates revenue grew at an annual average of 243% of the annual percentage increase in the State's CPI. That is, over these four years, the annual percentage increase in per-property residential rates revenue was nearly 2½ times the annual percentage increase in the State's CPI. When all types of rates are included in such a comparison (that is, commercial, industrial, mining and farmland rates as well as residential rates), total per-property rates revenue grew at an annual average of 213% of, or just over two times, the annual percentage increase in the State's CPI.

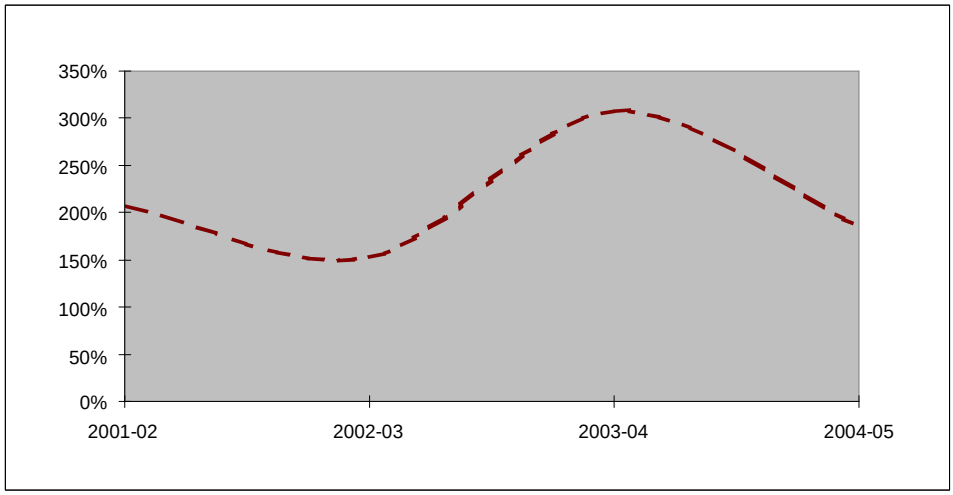
These percentages are evidence that WA councils have been increasing their standards of services as well as their rating effort. We use two rules of thumb developed in the SA and NSW Inquiries that:

- a per-property rates increase in the order of 150% of the annual increase in the CPI may represent the typical 'no-policy-change' rates increase; and
- a per-property rates increase in excess of double (i.e., 200% of) the annual increase in the CPI – if not accompanied by increases in service levels or standards – may reasonably give rise to ratepayer dissatisfaction.

4.2.4 RECENT HISTORY

Chart 4-1 shows recent annual movements in the relative rating effort of WA councils, as measured by the annual percentage nominal increase in per-property rates expressed as a percentage of the annual percentage increase in the State's CPI.

CHART 4-1: RELATIVE RATING EFFORT
ALL WA COUNCILS, 2000-01 TO 2004-05

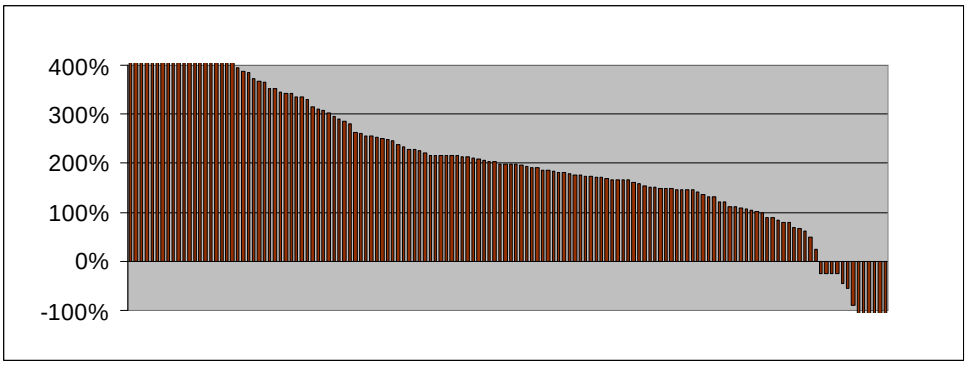


It is evident that this indicator has fluctuated within a 200% to 300% band over the period in question. Over the last four years, on a per-property basis, the rate of increase in the average rates bill has been two to three times the rate of increase in the CPI. This has been sufficient to finance some increases in levels of service as well as (as was pointed out in chapter 2) reduce council operating deficits.

4.2.5 DIFFERENCES WITHIN THE SECTOR

Differences evident among WA councils in their recent relative rating effort are shown in Chart 4-2.

CHART 4-2: RELATIVE RATING EFFORT
WA COUNCILS, 2000-01 TO 2004-05



69 councils or nearly 50% have grown their per-property rates collections over the last four years at an average annual nominal growth rate more than two times the State's annual CPI increase.

41 or just less than 30% increased their's by less than 1½ times the State's CPI.

Table 4-5 compares the relative rating effort of councils in each of the council groupings during recent years, both for residential rates and all types of rates combined.

TABLE 4-5: RELATIVE RATING EFFORT BY TYPE OF COUNCIL, WA COUNCILS, 2000-01 TO 2004-05

	no of councils	Residential growth rate as % of annual CPI increase	All types growth rate as a % of annual CPI increase
Metropolitan	29	196%	156%
Regional, with large towns	27	397%	379%
Regional, without large towns	86	288%	210%
Above-average growth	30	289%	206%
Declining population	71	288%	309%
Largest 25%	35	244%	215%
Smallest 25%	35	262%	191%
All WA Councils	**142**	**243%**	**213%**

Overall, we take this to be evidence that – unless it is clear that a council has a below-par rating effort – councils generally have been pushing the envelope when it comes to rates increases. In future, annual percentage increases in per-property rates collections at this level – let alone at higher levels – would reasonably give rise to ratepayer dissatisfaction.

4.2.6 ADDITIONAL REVENUE RAISING CAPACITY

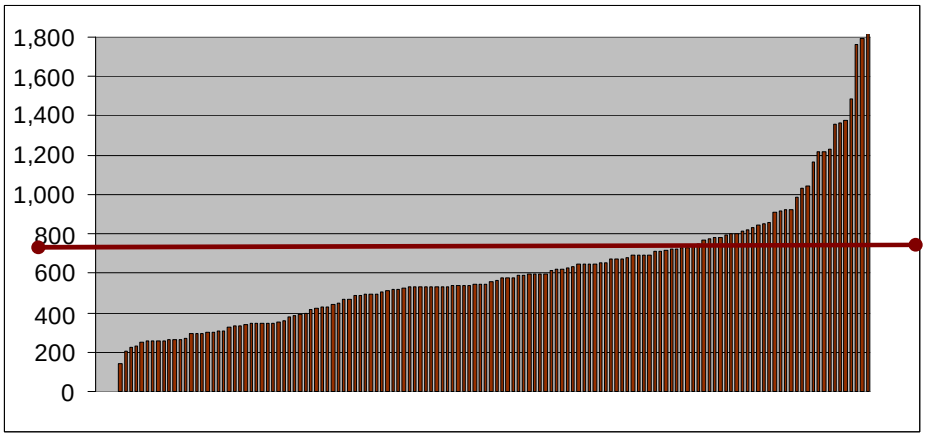
Whether there is any additional rates capacity therefore depends mainly on how a council's per-property rates revenue compares with its peers.

In our assessment of a council's financial capacity, we acknowledge the need to incorporate the additional financial capacity available associated with the council's application of a uniform higher revenue-raising effort. Rather than using average effort among WA councils, we prefer to use the upper bound of actual revenue-raising effort currently observed among councils in WA as the yardstick. Specifically, we take the upper-bound effort to be indicated by the minimum effort evident among councils displaying the highest quartile of effort.

On this basis, any council currently applying revenue-raising effort that is below the upper-bound effort currently observed among WA councils possesses a potential additional source of financial capacity.

Chart 4-3 shows the differences evident among councils in their rates revenue per *residential* assessment in 2004-05, with the horizontal line shown indicating the minimum revenue per assessment for councils in the highest quartile ($729 in 2004-05).

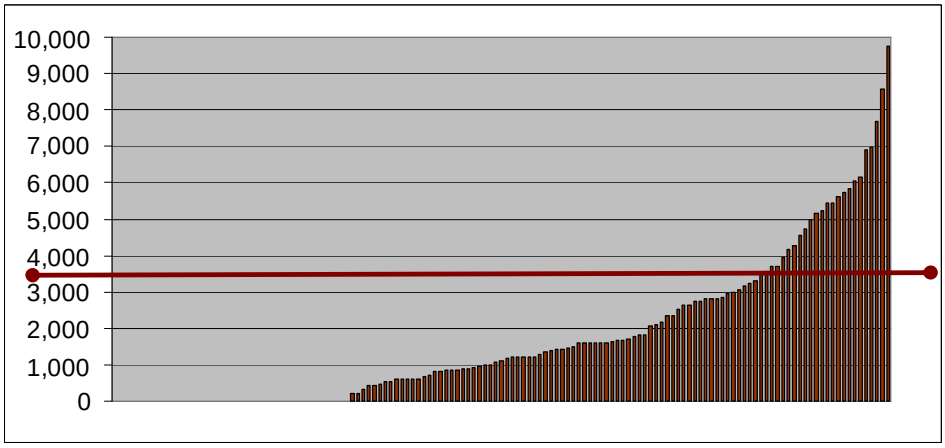
CHART 4-3: RATES REVENUE PER RESIDENTIAL ASSESSMENT ($)
WA COUNCILS, 2004-05



Councils with rating efforts below the higher-effort level shown possess a potential source of additional financial capacity.

Chart 4-4 shows the differences evident among councils in their rates revenue per *commercial* assessment in 2004-05, with the horizontal line shown indicating the minimum revenue per assessment for councils in the highest quartile ($3,540 in 2004-05).

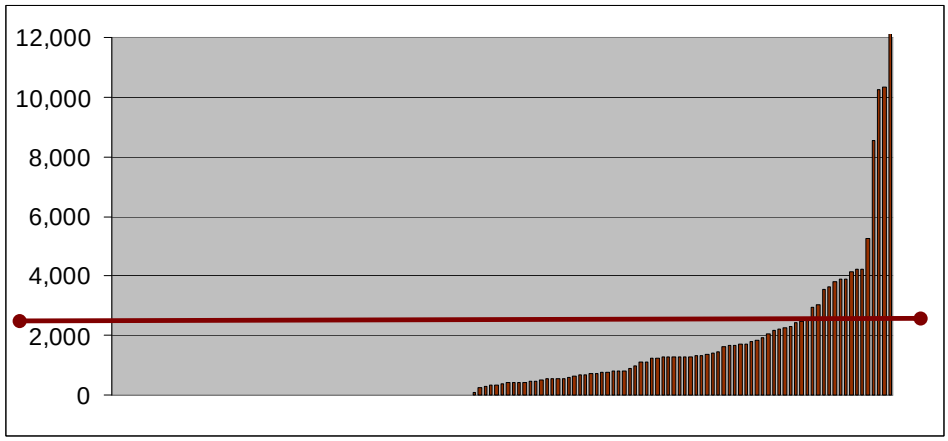
CHART 4-4: RATES REVENUE PER COMMERCIAL ASSESSMENT ($)
WA COUNCILS, 2004-05



Councils with rating efforts below the higher-effort level shown possess a potential source of additional financial capacity.

Chart 4-5 shows the differences evident among councils in their rates revenue per *industrial* assessment in 2004-05, with the horizontal line shown indicating the minimum revenue per assessment for councils in the highest quartile ($2,307 in 2004-05).

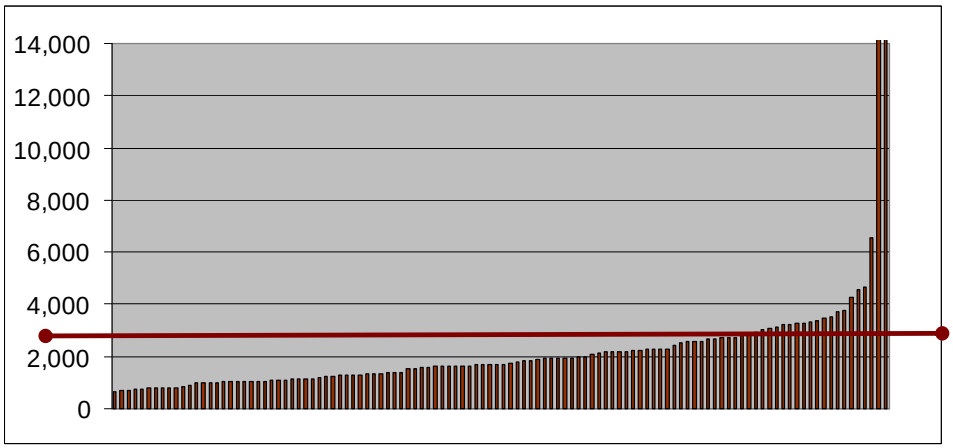
CHART 4-5: RATES REVENUE PER INDUSTRIAL ASSESSMENT ($)
WA COUNCILS, 2004-05



Councils with rating efforts below the higher-effort level shown possess a potential source of additional financial capacity.

Chart 4-6 shows the differences evident among councils in their rates revenue per *farmland* assessment in 2004-05, with the horizontal line shown indicating the minimum revenue per assessment for councils in the highest quartile ($2,591 in 2004-05).

CHART 4-6: RATES REVENUE PER FARMLAND[(a)] ASSESSMENT ($)
WA COUNCILS, 2004-05



(a) Farmland, rural & pastoral

Any council currently applying revenue-raising effort that is below the upper-bound effort currently observed among WA councils possesses a potential additional source of financial capacity.

Admittedly, a proportion of differences presently observed among councils in per-property revenue collections may be due to differences between them in average household and business income levels.

Assuming that only 50% of the observed differential in per capita residential rates collection could be eliminated were lower-effort councils to match the effort currently shown by higher-effort councils (and the same for 25% of the observed differential for commercial, industrial and farming rates collections), we estimate that total rates collections for those councils with operating deficits could increase by around $40 million or 6%. On its own, this

would see the average operating deficit for such councils fall to 11% of these councils' revised own-source revenue.

4.3 FEES AND CHARGES

4.3.1 BACKGROUND

When it comes to the scope for additional revenue-raising effort, it is necessary to look at not only a council's rating effort but also its revenue-raising effort with regard to fees and charges.

Under section 6.16 of the *Local Government Act 1995*, a council is empowered to:

> *(1) …impose and recover a fee or charge for any goods or service it provides or proposes to provide, other than a service for which a service charge is imposed.*
>
> *(2) A fee or charge may be imposed for the following —*
>
> *(a) providing the use of, or allowing admission to, any property or facility wholly or partly owned, controlled, managed or maintained by the local government;*
>
> *(b) supplying a service or carrying out work at the request of a person;*
>
> *(c) … providing information from local government records;*
>
> *(d) receiving an application for approval, granting an approval, making an inspection and issuing a licence, permit, authorisation or certificate;*
>
> *(e) supplying goods;*
>
> *(f) such other service as may be prescribed.*

Furthermore, section 6.17 provides that:

> *(1) In determining the amount of a fee or charge for a service or for goods a local government is required to take into consideration the following factors —*
>
> *(a) the cost to the local government of providing the service or goods;*
>
> *(b) the importance of the service or goods to the community; and*
>
> *(c) the price at which the service or goods could be provided by an alternative provider.*
>
> *(2) A higher fee or charge or additional fee or charge may be imposed for an expedited service or supply of goods if it is requested that the service or goods be provided urgently.*

In addition, section 6.38 of the Act provides that a council may impose on owners or occupiers of land within the district or a defined part of the district a *service charge* for a financial year to meet the cost of providing a prescribed service in relation to the land. WA councils impose garbage charges and (where applicable) water and sewerage charges.

Generally, the basis for determining a fee or charge is not limited to the cost of providing the service or goods. However, in prescribed circumstances, Regulations may prohibit the imposition of a fee or charge or limit the amount of a fee or charge.

In addition, councils raise other non-investment revenue through fees and fines, operating contributions and from other sources.

Table 4-6 indicates the level and composition of WA councils' revenue from fees and charges in total.

TABLE 4-6: FEES AND CHARGES BY TYPE, ALL WA COUNCILS, 2004-05

	$M	%
Fees and fines	15.2	2.9%
plus Service charges	97.0	18.7%
plus User charges	322.1	62.2%
plus Operating contributions	32.3	6.2%
plus Other income (not including investment income)	51.3	9.9%
equals **Fees and charges**	**517.9**	**100.0%**

4.3.2 ASSESSING THE ROLE FOR USER CHARGES

Fees and charges are typically used to finance services with a predominantly 'private' component, while taxes (such as rates) are used to finance those services with a substantial 'public' component.

The distinction between 'private' and 'public' goods and services hinges on two concepts – rivalry in consumption and excludability in consumption. A good or service is said to be *rival* if the consumption of a unit of it by one individual means that there is one unit less for everyone else to consume; a non-rival good is one for which provision of one unit for one person for his own consumption also enables consumption by others. A good or service is said to *excludable* if it is possible to prevent a person from enjoying the benefits that arise from it. Drawing on these two concepts:

- a pure private good is a good which is both rival and excludable in consumption;
- a pure public good is one which is non-rival and non-excludable; and
- a 'club good' is a good which is (at least partially) non-rival but excludable.

There is a considerable variation across local government functions in the degree to which benefits are believed to be public or private. In reality, many goods involve a combination of these attributes.

Nevertheless, the distinction between private and public goods has important implications for the structure of council revenue sources. Where private choice processes (including club approaches) are believed to be preferable to public choice processes, cost-reflective fees and charges are the best mechanism to promote efficient production and consumption choices. Where public choice processes are deemed to be necessary, it generally will be necessary to recover costs through tax revenue – either rates or grants from other governments.

If an externality exists, that is when one person's consumption of a good has an impact (positive or negative) on some third party, there may also be a case for the beneficiaries contributing to the cost of the service in question.

In New Zealand, legislation requires that councils identify the beneficiaries of services that they provide and attribute costs to them. Councils are then expected to raise funds according to these cost attributions, albeit with some modifications in the light of factors such as affordability, market neutrality, acceptability and consistency with strategic policies. Generally:[22]

[22] This list is sourced from SACES (2002).

- if those that benefit directly cannot be identified and/or if those that benefit directly cannot be excluded from using the service, the costs should be allocated to the community (public good). An example is footpaths.
- if a service (or activity) benefits identifiable individuals or group(s) the costs should be allocated to those individuals or group(s) (user pays). An example is rubbish bins.
- if there are indirect or 'flow-on' benefits and those that receive these benefits cannot be identified, the costs should be allocated to the community (positive externality). An example is libraries.
- if the service prevents the negative effects of the actions of (identifiable) persons, the costs should be allocated to those persons (polluter or exacerbator pays). An example is parking fines.

4.3.3 MEASURING COST RECOVERY EFFORT

We have calculated the extent to which a council's revenue from fees and charges recovers the council's own-purpose operating (and depreciation) expenses, with 'own-purpose' expenses defined as total expenses net of any expenses funded by operating grants from other governments.

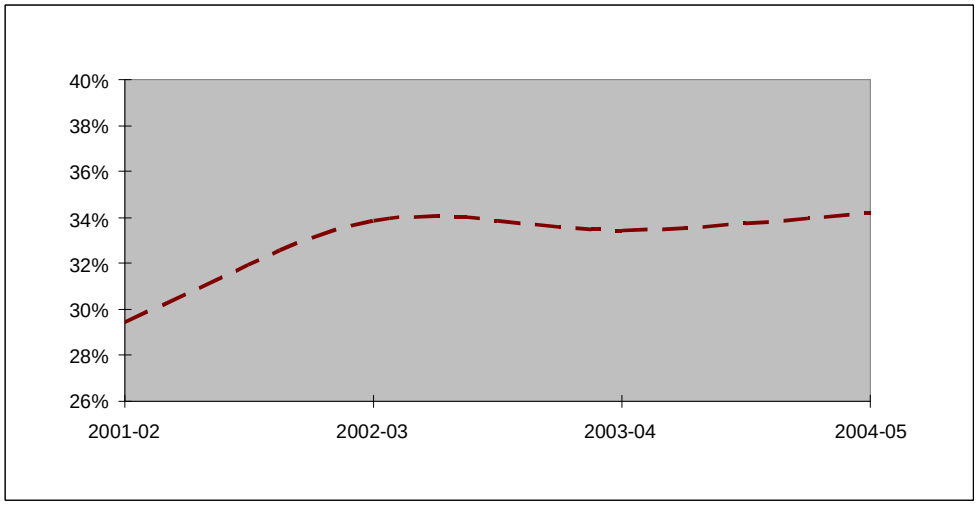
In this way, the additional financial capacity available as a result of each council achieving a cost recovery ratio equal to the upper bound of cost recovery currently observed among WA councils can be estimated.

In 2004-05, we estimate that WA councils on average recovered 34.1% of the council's own-purpose operating (and depreciation) expenses through the fees and charges they impose.

4.3.4 RECENT HISTORY

Chart 4-7 shows recent annual movements in the relative cost recovery ratios of WA councils.

CHART 4-7: RELATIVE COST RECOVERY EFFORT
WA COUNCILS, 2000-01 TO 2004-05

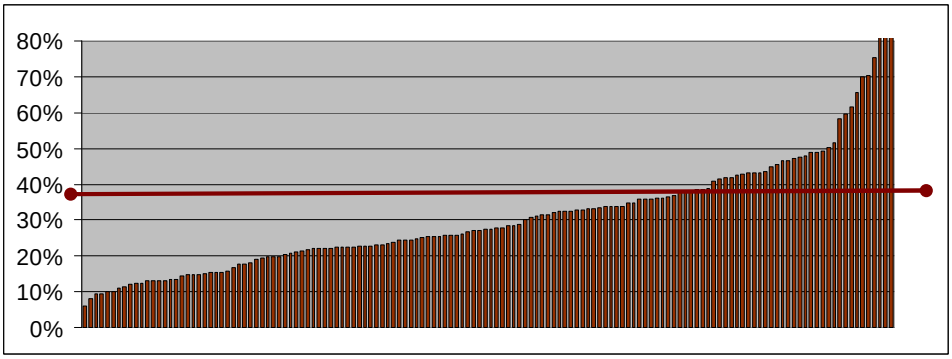


A gradual upward trend is evident in the average cost recovery ratio of WA councils.

4.3.5 DIFFERENCES WITHIN THE SECTOR

Chart 4-8 shows the differences evident among councils in their cost recovery ratios in 2004-05, with the horizontal line shown indicating the minimum cost recovery ratios for councils in the highest quartile of effort (38.1%).

CHART 4-8: COST RECOVERY RATIOS WA COUNCILS, 2004-05



Councils with relatively-low revenue effort in this area possess a potential source of additional financial capacity.

Table 4-7 compares the average cost recovery ratios of councils in each of the council groupings.

TABLE 4-7: COST RECOVERY RATIOS, BY TYPE OF COUNCIL WA COUNCILS, 30 JUNE 2005

	no of councils	%
Metropolitan	29	35.1%
Regional, with large towns	27	36.4%
Regional, without large towns	86	28.6%
Above-average growth	30	36.4%
Declining population	71	33.1%
Largest 25%	35	36.0%
Smallest 25%	35	30.4%
All WA Councils	**142**	**34.6%**

In our assessment, any council currently applying a cost recovery ratio below the upper-bound effort currently observed among WA councils possesses a potential additional source of financial capacity. Admittedly, a proportion of differences presently observed among councils in per capita revenue collections may be due to differences between them in average household and business income levels.

Assuming that only 50% of the observed differential in per capita collection levels would be eliminated were lower-effort councils to match the effort currently shown by higher-effort councils, we estimate that total fees and charges for deficit councils could increase by around $44 million or 17%. On its own, this would see the average operating deficit for such councils fall to 10.9% of these councils' own-source revenue.

4.4 DEVELOPER CHARGES

4.4.1 ROLE OF DEVELOPER CHARGES

Developer charges are lump-sum charges designed to recover costs incurred in the provision of infrastructure from the beneficiaries of that infrastructure, typically levied on the owners/developers rather than the occupiers of land or the users of specific services.

There are three main reasons for imposing developer charges:

- to augment council funding by taxing those who benefit directly from infrastructure improvement;
- on economic efficiency grounds, to levy those responsible for the development so that infrastructure costs are included in development decision-making; and
- on equity grounds, to charge those individuals who benefit from public investment in infrastructure.

Ideally, developer charges should involve full net cost recovery from the beneficiary, reflect variations in the cost of servicing different development areas, result in new developments meeting no more than the cost of the services provided through developer charges, cover infrastructure expenditures which can be clearly linked to the development and be reliably forecast, and be calculated in a transparent manner so that developers can understand and assess the calculated charges.

In general, developer charges shift the burden of financing new infrastructure from the community at large to the owners of developable land, developers, and buyers of new homes. The distribution of the burden among these groups, like any other tax, will depend on the price sensitivities of buyers and sellers in the market in question and on barriers to entry into this market. In broad terms, in the long run, the burden of developer contributions in residential developments will be borne by residents of new and existing housing in the form of higher housing prices and rents.

Much of the attention has been on residential development, but developer charges can also be levied against commercial and industrial development. The basic principle is that infrastructure should be paid for by its beneficiaries. In 'for-profit' development, economic benefits are easier to measure than the more qualitative benefits provided by residential development.

4.4.2 MEASURING DEVELOPER CHARGES EFFORT

No comprehensive data set is available on the level and composition of developer charges imposed by WA councils because such figures are not routinely published by councils.

Table 4-8 shows our estimates for 2004-05.

TABLE 4-8: DEVELOPER CHARGES
WA COUNCILS, 2004-05

	$M	%
Capital contributions (i.e., cash)	55.5	35.4%
plus		
Assets donated (i.e., non-cash)	101.3	64.6%
equals		
Developer charges	**156.8**	**100.0%**

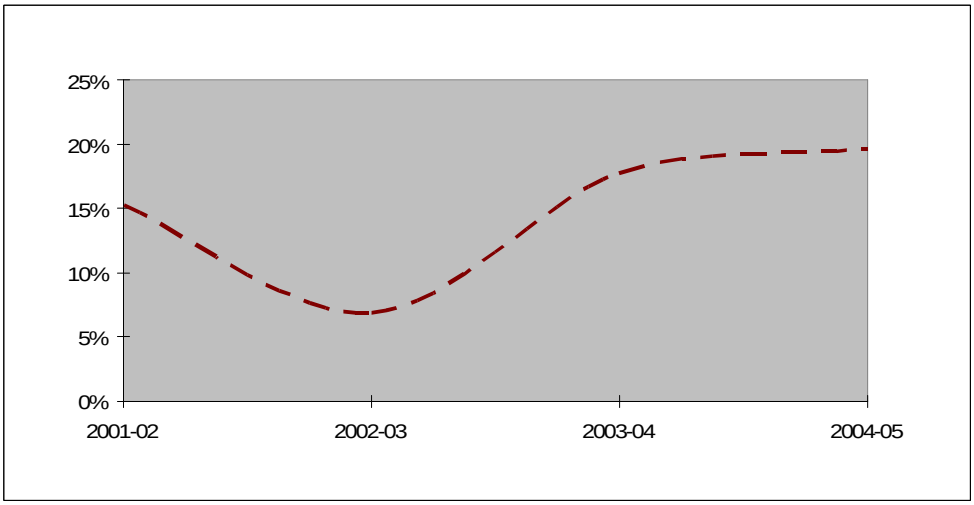
The level of developer charges effort can be proxied by expressing total developer charges as a percentage of total additions to non-financial assets (both assets acquired (capital expenditure) and assets donated).

In 2004-05, we estimate that developer charges as we have defined them on average have funded around 20% of all additions to non-financial assets.

4.4.3 RECENT HISTORY

Chart 4-9 shows recent annual movements in the developer charges ratios of WA councils.

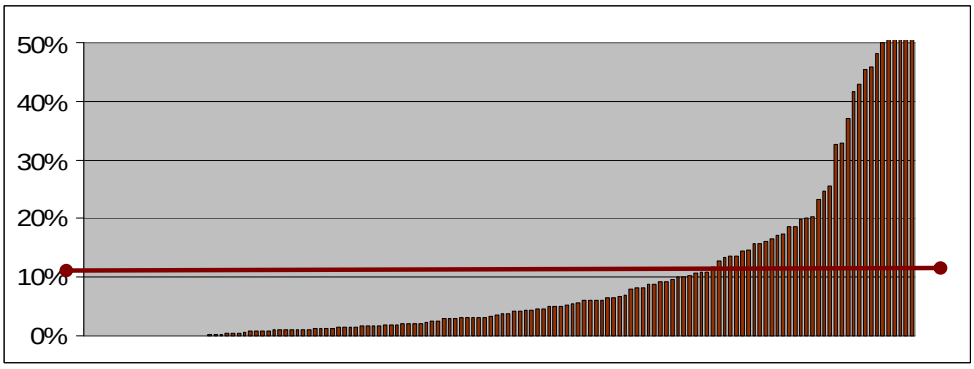
CHART 4-9: DEVELOPER CHARGES RATIO
WA COUNCILS, 2000-01 TO 2004-05



4.4.4 DIFFERENCES WITHIN THE SECTOR

Chart 4-10 shows the differences evident among councils in their developer charges ratios in 2004-05, with the horizontal line shown indicating the minimum developer charges ratio for councils in the highest quartile of effort (10.9%).

CHART 4-10: DEVELOPER CHARGES RATIOS
WA COUNCILS, 2004-05



While councils with relatively-low developer charges ratios may possess a potential source of additional financial capacity, we have chosen not to put an estimate on the additional revenue that might be involved because of uncertainties about the extent to which there is general scope for increased developer charges in the councils with apparently below-par developer charges ratios.

Moreover, until an acceptable framework for developer charges is put in place, there is a risk that sufficient checks and balances could be absent. Arrangements need to be in place to:

- avoid 'double-dipping' or overcharging: residents who have purchased property on which a developer charge has been levied to construct capital facilities should not then be asked to contribute monies towards the capital cost from rates or other levies;
- ensure equity on account of incidental benefits delivered to existing ratepayers through facilities to serve new ratepayers; and
- coordinate State versus local arrangements, with any imbalance between the two liable to distort the proper pricing of residential lands and add uncertainties.

4.5 KEY CONCLUSIONS

Councils themselves must be able to raise at least a fair slice of the revenue they need to cover the costs of providing services to their communities. If they cannot, service standards must fall, or financial sustainability may be compromised – or both.

Overall, rates revenue is predictable and stable and allows for a fairly high level of local financial autonomy. We consider that the local government rating system generally meets the criteria of administrative simplicity and efficiency, and – if administered carefully – is capable of being vertically and horizontally equitable.

Nevertheless, local government's use of taxation on property requires regular year-to-year resetting of the per-property rate of tax, because property values (the 'tax base' of council rates) increase year-on-year in ways that are unrelated to the cost of providing council services.

No-policy-change increases in (per-property) rates revenue should keep pace with annual expenses (over the business cycles), where expenses are prudent. Policy-change increases in (per-property) rates should be explicitly linked to increases in service standards or quantities.

On average, across all WA councils over the four years to 2004-05, total per-property rates revenue has grown each year at two to three times the annual percentage increase in the State's CPI.

Overall, we take this to be evidence that – unless it is clear that a council has a below-par rating effort – councils generally have been pushing the envelope when to comes to rates increases. In future, annual percentage increases in per-property rates collections at this level – let alone at higher levels – would reasonably give rise to ratepayer dissatisfaction.

We estimate that WA councils with operating deficits could more than halve their operating deficit ratios if those among them with below-par rates and cost-recovery efforts lifted their effort. This would result in around an 11% increase in these councils' own-source operating revenue. In addition, if an appropriate framework were put in place, there is also scope for increased developer charges in those councils not yet fully exploiting this form of cost recovery.

Admittedly, there are large differences among councils in their access to any available additional financial capacity. In particular, councils relying more on grants from other governments and less on their own-source revenue only have access to relatively low levels of additional financial capacity.

However, whether some of the identified own-source revenue increases materialise even on average will depend importantly upon the policies adopted by councils themselves. Much depends upon the willingness of councils to exploit any opportunities available for increasing their revenue-raising effort and the extent to which they are prepared to contain rates concessions in future.

5. THE FINANCIAL SUSTAINABILITY OF WA COUNCILS

This chapter provides our assessment of the financial sustainability of local government in Western Australia.

5.1 DEFINITION AND MEASUREMENT ISSUES

5.1.1 WHAT DOES FINANCIAL SUSTAINABILITY INVOLVE?

The Commonwealth Government defines fiscal sustainability (with 'fiscal' sustainability and 'financial' sustainability being inter-changeable in a public sector context) as:

> *"…a government's ability to manage its finances so it can meet its spending commitments, both now and in the future. It ensures future generations of taxpayers do not face an unmanageable bill for government services provided to the current generation.*
>
> *…One of the key requirements for sustainable government financial arrangements is a balanced budget over the medium to long term, given a reasonable degree of stability in the overall tax burden." (Commonwealth Government, Intergenerational Report, May 2002)*

The NSW Government defines fiscal sustainability as follows:

> *"Fiscal sustainability requires that the Government be able to manage financial risks and financial shocks in future periods without having to introduce significant and economically or socially destabilising expenditure or revenue adjustments in those future periods. What is considered consistent with fiscal sustainability will vary depending on the strength and outlook for the economy, the structure of expenditure and revenue of the budget, the outlook for the State's credit rating, demographic and social trends that will affect the budget, and the nature of financial risks faced by the Government at any given time." (NSW Government, Fiscal Responsibility Act 2005, section 3(1))*

Combining these definitions with the financial capacity concept used in chapter 4, our definition of financial sustainability is as follows:

> *A council's finances are sustainable in the long term only if its **financial capacity** is sufficient – for the foreseeable future – to allow the council to meet its expected **financial requirements** over time without having to introduce substantial or disruptive revenue (and expenditure) adjustments.*

Effectively, a financial sustainability assessment involves a comparison of a council's long-term financial capacity with its long-term financial requirements.

A council's *financial capacity* was defined in chapter 4 as the funding (both operating and capital) that can be mobilised through its existing revenue-raising and financing policies and any additional funding available were the council to increase its revenue-raising efforts to levels commensurate with those displayed by higher-effort councils.

A council's *financial requirements* involve:

- the spending (both operating and capital) necessary to meet both its statutory obligations and any expected spending pressures (which in the case of local government is principally associated with addressing the asset maintenance and renewals backlogs canvassed in chapter 3); as well as

- the margin of comfort necessary for the council to be able to manage any future financial shocks.

If a council's long-term finances are sustainable in this sense, then disruptive rates increases or spending cuts can be avoided, the rating burden will be shared fairly between current and future ratepayers and the stability or predictability of a council's rates will not be at risk.

5.1.2 HOW DOES FINANCIAL 'SUSTAINABILITY' DIFFER FROM 'VIABILITY'?

It is important to note that a council being classified as financially 'unsustainable' does not imply the council's *financial viability* is necessarily in question.

As we use the term, 'unsustainable' finances in the long term refers only to the unsustainability of a council's current policies, both revenue-raising and spending. Council finances can almost always be corrected with substantial rating increases and/or expenditure cutbacks, albeit at a considerable cost to ratepayers and the community being served.

By contrast, the term 'financial viability' is used in the private sector in relation to whether an entity's financial performance and position does not jeopardise the interests of its creditors. In the local government context, this implies allowance can be made for whatever increases in tax effort may be necessary for a council to stave off defaulting on its debt service obligations. As political sustainability may be reached beforehand, with tax increases jeopardising an elected council's position, financial sustainability is a higher hurdle, focussing primarily on protecting the interests of a council's ratepayers rather than only its creditors.

Besides, there can be no doubt that the local government sector is, and will always be, financially 'viable' in the sense that it will always be able ultimately to meet its debt service obligations. Ratepayers are bound to meet all outstanding obligations under the *Local Government Act*.

Hence, in contrast to the meaning given to 'financial viability' in a corporate context, financial sustainability in the sense that we – and governments generally – use the term focuses on the prevention of *tax 'shocks'*. A council's finances can be judged to be sustainable in the long term only if they are strong enough – currently and in the foreseeable future given likely developments in the council's revenue-raising capacity and in the demand for and costs of its services and infrastructure – to allow the council to manage financial risks and financial shocks over the long-term financial planning period without having to introduce substantial or disruptive revenue (or expenditure) adjustments during that period.

5.1.3 SUSTAINABILITY ASSESSMENT FRAMEWORK

Translating council finances into an assessment of the sustainability of those finances requires assessments at the individual council level.

In the circumstances currently applying to local government in Australia, we consider the main indicator of the sustainability of a council's long-term finances to be the council's *underlying* operating deficit as a percentage of its own-source revenue. This ratio indicates the percentage increase in the council's own-source revenue (including rates revenue) that would be necessary to eliminate any 'structural' operating deficit. Operating deficits cannot persist over the long term, as they involve services consumed by current ratepayers being paid for by future ratepayers either by borrowing or by avoiding essential maintenance and renewal of existing assets. Persistent operating deficits are indicative of a council's revenue-raising effort being too low. Likewise, excessive operating surpluses can indicate that a council's revenue-raising effort is too high.

Chapter 2 presented basic data on the *currently-observed* operating deficits of WA councils. However, for reasons discussed below, a council's currently-observed operating deficit is only a starting point for a financial sustainability assessment.

First, councils could maintain operating deficits as high as 10% of their own-source revenue without their finances necessarily being assessed as unsustainable, on the grounds that a 10% deficit could be eliminated if necessary by 'manageable' increases in rates and other charges, that is increases that would fall short of qualifying as 'substantial'. We base this 10% figure on 10 year's worth of annual increases in rates and other charges at one percentage point per annum above the no-policy-change increase. Even for councils currently with relatively-high revenue-raising effort, an additional one percentage point annual increase in own-source revenue above the no-policy-change increase may just be tolerable. Increases beyond this could reasonably be described as 'substantial', and therefore constitute evidence that a council's present policies are unsustainable. Hence, we do not consider increases at the higher rates observed over the past four years – which have been at 2½ percentage points above what we consider to be the no-policy-change increase – to be sustainable.

Secondly, currently-observed operating deficits do not recognise the spending pressures that will arise as councils address their infrastructure backlogs. Instead of endeavouring to forecast what the budgetary impact of such future spending pressures might be, we have opted instead to attribute a nominal interest expense on account of each council's estimated backlog. A council's currently-observed operating deficit is understated to the extent that past operating deficits had been financed, not by borrowings, but by deferral of the maintenance and renewal of existing assets. The allowance for a higher interest bill indicates the expenses that a council would have been facing had it borrowed to finance its past operating deficits rather than funded those deficits by deferring asset maintenance and renewals. Attributing a nominal interest expense to the council's accumulated backlog is more straight-forward that putting a figure on the additional maintenance costs and capital expenditure that would go with any non-debt financed removal of the backlog. However, we recognise this allowance is only an approximation rather than a precise estimate, and if anything could understate the cost pressures implied as infrastructure backlogs are progressively addressed.

Thirdly, currently-observed operating deficits (or the 10% deficit benchmark we have chosen) do not allow for the additional financial capacity available to those councils with below-par revenue-raising efforts as discussed in chapter 4. Such councils would be justified, and have the means, to increase their own-source revenue at a rate faster than normal without imposing an above-par revenue-raising effort on their ratepayers.

Another candidate for the adjustment of currently-observed operating deficits when assessing the financial sustainability of councils would be the impact of likely expenditure trends on a no-policy-change basis on account of population shifts and ageing along with increasing environmental imposts. However, we have not undertaken the scenario work necessary for such an adjustment. Our experience in the NSW and SA Inquiries was that such scenario work added little to the analysis, with the allowance made for infrastructure backlogs and additional revenue-raising capacity being far more significant.

On this basis, we would classify only those councils with *backlog- and revenue-adjusted* operating deficits that are in excess of 10% of their own-source revenue as being 'financially unsustainable'.

5.2 INDIVIDUAL COUNCIL ASSESSMENT

We have applied the adjustments outlined in the above section to (or using) the data for WA councils presented in chapters 1 through 4.

Table 5-1 summarises the results of these adjustments at the council grouping level.

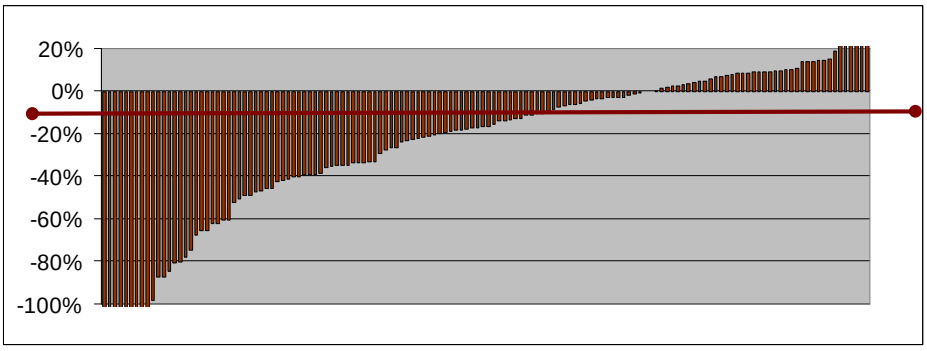
TABLE 5-1: CALCULATION OF ADJUSTED OPERATING SURPLUS/(DEFICIT) RATIOS WA COUNCILS, 2004-05

	actual surplus/ (deficit) ($M)	*less* **nominal interest on backlog ($M)**	*plus* **add'l revenue capacity ($M)**	*equals* **adjusted surplus/ (deficit) ($M)**	*divided by* **adjusted own-source revenue ($M)**	*equals* **adjusted operating surplus/ (deficit) ratio (%)**
Metropolitan	12.3	24.3	65.2	53.2	993.1	5.4%
Regional, with large towns	-38.5	46.1	25.9	-58.7	348.0	-16.9%
Regional, without large towns	-38.0	49.0	31.4	-55.6	196.3	-28.4%
Above-average growth	-17.3	31.7	48.1	-0.9	581.0	-0.2%
Declining population	-46.7	55.2	27.1	-74.8	276.2	-27.1%
Largest 25%	-13.2	52.1	76.0	10.7	1,193.5	0.9%
Smallest 25%	-6.9	11.9	6.7	-12.2	52.8	-23.0%
All WA Councils	**-64.2**	**119.5**	**122.5**	**-61.1**	**1,537.4**	**-4.0%**

It is evident that, in total, the allowance made for the impact of the infrastructure backlogs identified in chapter 3 broadly corresponds with the offsetting allowance made for the additional revenue-raising capacity available to many councils identified in chapter 4. There are, however, important differences between the two types of allowances at the individual council group level.

Chart 5-1 shows the differences among councils in their operating surpluses or deficits as adjusted for their infrastructure backlogs and additional revenue-raising capacities. The horizontal line shows the benchmark deficit of 10%.

CHART 5-1: BACKLOG- AND REVENUE-ADJUSTED OPERATING SURPLUS RATIO WA COUNCILS, 2004-05



By inspecting the chart, it is evident that just over one council in every two would require a substantial (i.e., greater than 10%) further increase in their own-source revenue to eliminate their underlying operating deficits. In fact, on this basis, it is our assessment that the long-term finances of 83 WA councils are currently unsustainable. These councils serve 21% of the State's population.

That said, it is important to repeat that being classified as unsustainable does not mean a council is in imminent danger of defaulting on its debt service obligations. That is, the council's financial viability is not necessarily being called into question. Rather, what is being flagged is that substantial or disruptive revenue (or expenditure) adjustments appear inevitable if the long-term finances of such a council are to be corrected.

Our assessment that the long-term finances of councils serving 21% of the WA's population are 'unsustainable' compares with our earlier assessments for the NSW and SA Inquiries where:

- in NSW, 25% of that State's councils were assessed as financially unsustainable, with such councils serving 17% of the State's population; and
- in SA, 50% of that State's councils were assessed as financially unsustainable, with such councils serving 50% of the State's population.

While the percentage of councils assessed as financially unsustainable is considerably higher for WA than for NSW, the WA and SA percentages are broadly similar. That said, the magnitude of the problem in SA appears much greater than in WA at least as indicated by the share of State population served by such councils, with the population shares affected being broadly similar in WA and NSW.

5.3 ROLE OF COUNCIL SIZE AND STRUCTURE

As Table 5-2 illustrates, the WA councils which we assess to be financial unsustainable have a range of structural characteristics.

TABLE 5-2: FINANCIAL SUSTAINABILITY ASSESSMENT: BY TYPES OF COUNCILS

Type of council	Councils whose long-term finances are assessed as unsustainable:			
	number	% of total	% of type	% of State pop'n
Metropolitan	3	4%	10%	5%
Regional, with large towns	19	23%	70%	11%
Regional, without large towns	61	73%	71%	5%
Above-average growth	13	16%	45%	8%
Declining population	53	64%	75%	9%
Largest 25%	11	13%	31%	12%
Smallest 25%	24	29%	69%	1%
All WA Councils	**83**	**100%**	**58%**	**21%**

Financial sustainability does not appear to be too much of a problem for metropolitan councils in WA, with only three such councils (or 10% of metropolitan councils) assessed as unsustainable.

Instead, the councils whose finances are most likely to be unsustainable in the longer term are mainly regional councils, and those with declining populations and small population bases at that. We have assessed 70% or so of each of these council groupings as financially unsustainable. Three-quarters of the councils we have assessed as being unsustainable are regional councils without large towns.

In WA, to an extent not evident in either NSW or SA, financial unsustainability is a problem particularly prevalent among smaller and/or declining population regional councils. It is hard to deny that this is evidence of a structural problem within local government in WA.

However, interestingly, 31% of the largest councils and 45% of the above-average growth councils are also assessed as financially unsustainable. This suggests to us that more factors are at work in explaining the sustainability of a council's long-term finances than just whether it is small in size or has stagnant growth characteristics.

5.4 KEY CONCLUSIONS

The long-term finances of a majority of WA councils look unsustainable, when account is taken of infrastructure backlogs and despite the additional revenue-raising capacity many of them have because of their current below-par revenue efforts.

In fact, for these councils, the additional financial capacity they have is not sufficient either to eliminate their currently-observed operating deficits and/or address the infrastructure backlogs that they have been building up for some time.

Being classified as unsustainable does not mean a council is in imminent danger of defaulting on its debt service obligations. The financial viability of such councils is not necessarily being called into question. Rather, what is being flagged is that substantial and disruptive revenue (or expenditure) adjustments appear inevitable if the long-term finances of such a council are to be put onto a sustainable basis going forward.

The councils whose current policies seem unsustainable over the long term are mainly regional councils, which include most of the State's smallest and declining population councils. This is evidence of a structural problem in WA's local government sector not apparent in NSW and SA for example. Larger as well as above-average growth rate councils are sufficiently well represented among those whose finances we would classify as unsustainable to indicate that more factors are at work in explaining the sustainability of a council's long-term finances than just its small size or stagnant growth.

In the absence of additional grant funding from other governments, our assessment is that the long-term finances of at least one in every two WA councils are unsustainable. For such councils, our assessment is that substantial rates increases (or disruptive expenditure cuts) – on top of the additional revenue-raising effort we have factored-in for low-effort councils – will be required if their (existing and emerging) budgetary imbalances are to be corrected.

BOX: An Invitation to Undertake a Self-Assessment

While Access Economics has not identified its assessment of the financial sustainability status of individual WA councils, a council can undertake a self-assessment by applying data from 2004-05 or from the current budget year using the Access Economics' methodology as follows:

financial aggregates	latest year
Surplus/(deficit) after capital amounts [as per AAS27]	$ _____
less the portion of annual capital grants from other governments intended to finance asset renewal, upgrading and expansion as opposed to annual maintenance expenses	$ _____
less the portion of 'contributions' intended for capital purposes	$ _____
less any gains from asset sales net of any losses	$ _____
less any gains from asset revaluations net of any losses	$ _____
plus the council's estimated additional annual revenue were it to adopt the same rating effort as its higher-effort peers	$ _____
plus the council's estimated additional annual revenue were it to adopt the same cost-recovery effort via its fees and charges as its higher-effort peers	$ _____
less the council's estimated average additional annual expenses were its infrastructure backlog to be cleared in full over the next 5-10 years (including the interest costs associated with any associated additional borrowing, whether to finance any additional capital expenditure or the higher operating costs that could not be met from a revenue-raising effort equivalent to that of its peers)	$ _____
equals **the council's backlog- and revenue-adjusted operating surplus/(deficit)**	$ _____
divided by the council's total (adjusted) annual *own-source* revenues, i.e., including the council's additional annual own-source revenue were it to adopt the same revenue effort as its higher-effort peers (as estimated above)	$ _____
equals **the council's *backlog- and revenue-adjusted* operating surplus/(deficit) ratio**	_____ %

If the resultant *backlog- and revenue-adjusted* operating surplus/(deficit) ratio is negative and that negative value is greater than 10%, then substantial or disruptive revenue (or expenditure) adjustments would seem inevitable – based upon continuation of current policies – if the council's long-term finances are to be put onto a sustainable basis going forward.

It should be noted that the result a council might get applying the above methodology may differ from that which Access Economics may have derived for the council for the purposes of its SSS report or which it would have derived if it had access to the council's own estimates.

6. FINANCIAL GOVERNANCE IMPROVEMENTS

This chapter puts forward our recommendations for generally improving the financial health and governance of WA councils.

In our view, the prevalence of operating deficits and their frequent co-existence with substantial infrastructure backlogs are symptomatic as much of deficiencies in council spending and revenue policy frameworks – compounded by poor information and understanding of asset management – as they are of shortfalls in the level and escalation of grants from other governments and any past cost shifting.

Our focus in this chapter is therefore on policy changes within the control of each council. Broader structural and funding solutions are important matters to be addressed elsewhere in the Systemic Sustainability Study.

6.1 ASSET AND LIABILITIES MANAGEMENT FRAMEWORK

6.1.1 DEFICIENCIES

ASSET RECORDING AND MEASUREMENT

While the introduction of accrual accounting has compelled councils to establish asset registers to record and value assets, the structure and detail of information in these registers is still not uniform or complete.

Unlike the cases in NSW and SA, there are minimal accounting requirements for councils to group assets into uniform classes and sub-categories. There is no equivalent in WA to the guidance provided by the NSW Department of Local Government on asset classifications. This reduces both consistency and comparability in the asset data reported by WA councils themselves, which was evident from returns provided in the asset survey we undertook for the purposes of this report.

In addition, inconsistencies in asset valuation approaches are evident. Different approaches can change the interpretation of councils' financial position and performance. 'Fair value' valuations of asset items tend to be higher than 'at cost' valuations. As long as councils continue with 'at cost' valuations, they will be underestimating their true asset values and therefore also understating the extent of depreciation expense in their financial reports.

Making matters worse, councils are not obliged to use consistent depreciation rates for identical assets. There still exists a range of useful life estimates for (apparently) similar assets and this results in depreciation charges that also show wide variation and impact upon each council's operating surplus/(deficit). This makes comparison between councils difficult.

ASSET MANAGEMENT

Asset management refers to a process for 'whole of life' asset management from planning, purchase, maintenance and disposal of assets.

The underspending on the renewal of existing infrastructure by WA councils is evidence in part of inadequacies in asset management practices. Only a small proportion of councils have asset management policies in operation, or plans to establish asset management practices. Too little consideration is given to the extent to which future generations are expected to pick up the tab for renewing council-provided infrastructure.

LIABILITIES MANAGEMENT

On the liabilities management side, *credit foncier* and fixed interest borrowings still predominate.

6.1.2 RECOMMENDATIONS

Improving asset management and unifying infrastructure accounting is critical to addressing infrastructure problems, including by giving both councillors and the community a better understanding of the infrastructure challenge.

Each council should be working towards adoption of a total asset management system for the whole of life planning, funding, acquisition, registration, accounting, operation, maintenance, disposal, and renewal or enhancement of each component of its infrastructure. Minimum asset management requirements should be mandatory although phased in over time and with additional requirements added progressively.

An asset management framework that meets accepted industry standards should include:

- a clear definition of the services to be provided by each of its classes of infrastructure;
- a detailed knowledge of the assets held (thereby allowing predictions to be made about performance);
- the risks associated with managing the infrastructure being well understood;
- asset-related spending distinguishing between spending on the maintenance, renewal, upgrading and expansion of assets; and
- the cost of long-lived assets over their useful lives being accurately recognised.

Something similar to the Municipal Association of Victoria's (MAV) staged asset management improvement program should be developed and applied to WA council, aimed at increasing the asset management capability in the local government sector.[23] The Step program has been building infrastructure asset management capacity over recent years by promoting awareness raising of asset management obligations to all councils, and by providing tools and templates to assist in developing asset management policies, asset management strategies, asset management plans and operational plans. This voluntary program funded by the councils is delivered though six monthly visits to them by MAV-appointed consultants who identify priority deficiencies in asset management, score each council in respect to asset management adequacy though a series of questions and provide targeted training and improvement recommendations to be completed by the next visit.

In the process, accounting inconsistencies should be resolved by requiring:

- a standard format for asset registers;
- regular valuation of infrastructure at 'fair value';
- common definitions to enable the maintenance, renewal, upgrading and expansion of assets to be distinguished; and
- a standard depreciation schedule for assets whose total life has not been personally estimated by an expert assessor.

[23] See MAV (2003).

Additional reporting requirements in council annual reports should be introduced to deal with the infrastructure renewals gap.

On the liabilities management side, councils should avoid undertaking separate or specific borrowing to finance particular projects or assets, and rely instead on taking a coordinated approach to managing a council's borrowings and financial investments. Associated with this, councils should be managing their interest rate exposures in an up-to-date and deliberate fashion.

6.2 SERVICES POLICIES

6.2.1 DEFICIENCIES

Both the NSW and SA Inquiries concluded that, at the individual council level, regular reviews of existing programs and of the consistency of new policy proposals with a council's accepted roles and functions seem to be the exception rather than the rule. There is no reason to believe the situation is much different in Western Australia.

As a result, councils generally are likely to be too prepared to accommodate operating spending pressures. This seems to be associated with an inadequate understanding of the ongoing financial impact of such decisions, and insufficient scepticism about expanding the role of councils – at least without commensurate increased access to the necessary financial resources.

6.2.2 RECOMMENDATIONS

As required of councils by law in New Zealand, each WA council should be encouraged to develop and publish a 'services policy' statement clearly stating the roles and functions that it is prepared to adopt and specifying its policies regarding the number and nature of services to be delivered and the methods for delivery. Such a statement can then be the basis for:

- all new policy proposals being subject to rigorous analysis; and
- a regular cycle of program reviews being in place.

6.3 REVENUE AND FINANCING POLICIES

6.3.1 DEFICIENCIES

Both the NSW and SA Inquiries also concluded that few councils appear to have developed or implemented a rigorous policy framework for funding their services and infrastructure. This is undoubtedly the case also for WA councils. As a result, the current funding approach relies heavily on the use of rates revenue to fund the difference between estimated operating expenses and non-rates revenue each year. Limited consideration is given to the linkage of service beneficiaries to the funding source for each service provided by council through greater application of user charges.

6.3.2 RECOMMENDATIONS

Each council should be encouraged to develop and publish a 'revenue and financing policy' statement (similar to the statement required of councils by law in New Zealand), which ensures the adoption of a comprehensive and 'economic' approach to funding decisions. Such a statement would state (for example) the role to be played by 'user pays' and how any grants shortfalls are to be covered for services provided through grants funding. It would also provide the basis to examine the role to be played by developer charges.

6.4 FINANCIAL MONITORING AND ACCOUNTABILITY

6.4.1 DEFICIENCIES

EXTERNAL FINANCIAL REPORTING

The general purpose financial reports published by councils are entirely historical. Only a few councils prepare medium- to long-term (10 year) financial plans, and these vary in quality.

Information on some key financial aggregates is not published as a matter of course, notably annual capital expenditure let alone its renewals, upgrading and expansion components. Related to this, there are no comprehensive council-by-council figures on the extent of any infrastructure renewal backlog.

Maintenance expenses are not usually distinguished from other operating expenses in WA councils' financial reports. Differences are also likely to exist between councils regarding the extent that capital-related expenditure is expensed (as maintenance) or capitalised. This gives rise to the possibility that some recorded maintenance expense involves spending that extends the life of existing assets.

There are apparent differences too between councils in the accounting treatment of grants received from other spheres of government.

Disappointingly, the introduction of AAS27 has not given rise to comparability in financial reporting, as the information reported does not always enable valid comparisons to be made between different councils. Year-to-year consistency is also an issue.

While AAS27 does not require disclosure of performance indicators, the WA financial management regulations make them mandatory.[24] However, the financial indicators prescribed under WA regulations principally focus on balance sheet indicators (among them the current ratio and the untied cash to trade creditors ratio) which by themselves generally are uncertain predictors of the sustainability of a council's long-term finances.

Moreover, considerable confusion exists within local government about the interpretation of operating statement deficits and surpluses, in particular whether operating surpluses should be measured before or after capital revenue. AAS27 includes both operating surplus measures in a council's operating statement, with no guidance provided at all as to the relevance of each concept.

This range of deficiencies can be attributed to a number of factors, notably:

- scepticism about the funding (and interpretation) of depreciation, importantly but not entirely associated with uncertainties about the accuracy of current measurement of depreciation;
- the absence of a consensus within local government about desired financial performance 'outcomes'; and
- a lack of analysis of past financial position and performance data for WA councils, due in part to the limited availability of comparable and consistent data.

[24] Regulation 50(1) of the *Local Government (Financial Management) Regulations 1996* requires each WA council's annual financial report to include, for the financial year covered by the annual financial report and the two preceding financial years:

- the current ratio;
- the debt ratio;
- the debt service ratio;
- the rate coverage ratio;
- the outstanding rates ratio;
- the gross debt to revenue ratio;
- the untied cash to trade creditors ratio; and
- the gross debt to economically realisable assets ratio.

INTERNAL FINANCIAL REPORTING

Given the many inadequacies of external financial reports, it is not surprising that in-house financial briefing papers for councillors varies in quality with no agreed best-practice simple format.

The problems may not end there, however. Despite implementation of AAS27 in the early 1990s, much internal reporting within local government still has a cash accounting focus, thereby downplaying the operating surplus in the annual Statement of Financial Performance. Traditional cash accounting can easily lead to a misleading picture of commitments undertaken when payments can be accelerated or deferred. For instance, in cash accounting, no provision is made for funding depreciation of non-financial assets, with the result that when such assets need to be renewed there may be no funds set aside for doing so – the very situation that most councils now find themselves in.

FINANCIAL ACCOUNTABILITY

Inadequate expertise and understanding among councillors and senior officers regarding financial governance – and the accountabilities of councillors for the sustainability of their council's long-term finances – also seem to be playing a role. Across local government in Australia, there is limited training available to help councillors without accounting skills to understand accounts, let alone frame fiscal strategies, set budget priorities and monitor results.

6.4.2 RECOMMENDATIONS

Information about a council's finances, whether reported externally or internally, should be *relevant* in the sense that it has the capacity to make a difference in its informational or accountability role.

The information reported should be *timely*, and have the capacity to confirm or correct prior expectations about past events or to assist in forming, revising or confirming expectations about the future.

Financial information should also be:

- *consistent* – where the information reported enables valid comparisons to be made for the council over periods of time;
- *comparable* – where the information reported enables valid comparisons to be made between different councils; and
- *reliable* – where the information reported corresponds with the actual underlying transactions and events, is capable of independent verification and is reasonably free from error and bias.

Development of uniform accounting policies could take the form either of the WA Department of Local Government and Regional Development developing an accounting policy manual such as the NSW Department of Local Government's *Code of Accounting Practice and Financial Reporting*, or the Local Government Association of South Australia's *A Framework for Local Government Financial Management*.

Such a code could also make in mandatory, like the NSW code, that where there is a change in council policy which affects the calculation of performance ratios, the change in policy must be stated, and ratios under the new policy provided for the current period and the three previous years.

Relevant financial information should be provided in forecast form as well as in historical form. Prospective information should be available in both narrative and quantitative form. The narrative form should provide an assessment of prospects focussing on anticipated changes in the economic environment. The quantitative form should take the form of information about the council's future financial position and performance based on assumptions about future economic conditions and courses of action.

As per the CPA Australia (CPA (2005)) and the Municipal Association of Victoria (MAV (2004)) good governance guides, councillors should:

- recognise that, collectively, they are accountable for the financial sustainability of their council;
- ask enough questions to enable them to understand the council's financial position and performance, and have access to all appropriate financial information;
- be in the forefront of setting quantitative target values for the council's financial key performance indicators (KPIs);
- ensure that the longer-term financial plan is reviewed regularly;
- understand and be comfortable with the assumptions and strategies underpinning the long-term financial plan;
- respect and adhere to the plan once it has been developed; and
- focus at all times on overall community benefit rather than on particular sectoral interests.

Spending and revenue decisions should be taken in a multi-year framework, and against the background of long-term financial rules. Otherwise, the natural short-term focus of political decision-makers may cause councils to lose sight of future costs of decisions, the best allocation mix and the appropriate timing of spending. A council's budgetary forward estimates framework should be the first three to five years of its long-term (10 year) financial plan.

The council's general manager/CEO and senior managers should be offering up-to-date advice on all matters pertaining to financial governance and accountability, and ensuring that the necessary information systems are in place. The financial reports provided to councillors should be sufficient to ensure good financial governance. Being internal reports, they should present a council's finances in a way that is intelligible to non-financial people.

Local government should adopt a clear statement of the role and accountabilities of councillors for financial governance in general and the financial sustainability of their councils in particular. The separation of these roles and accountabilities from those of general manager and senior managers could be acknowledged (financial governance is primarily the responsibility of councillors, and cannot be delegated to a council's administration). Obligations required of councillors should be made more explicit (and strengthened), including the importance of councillors adopting a whole-of-council approach and the need of councillors to be more strategic. The part to be played by further training of councillors in support of these financial governance responsibilities could be reinforced.

Independent review of processes and decision-making should be undertaken regularly to assist the council to meet its accountability to ratepayers and the community, including with an audit committee overseeing and advising the council on matters of accountability and internal control.

The WALGA should promote the use of a comprehensive list of financial KPIs and an appropriate range of lower and upper benchmarks for each KPI. This would put local government in control of devising necessary financial targets and rules, as well as provide the maximum degree of flexibility in choosing and explain the suggested financial targets and rules. The financial KPIs used should have a strong predictive relationship with the degree to which a council's finances are likely to be sustainable in the long term, and be based upon generally-accepted key analytical balances. A council should set target values, and where appropriate also minimum (floor) and maximum (ceiling) values, for each of these financial KPIs.[25]

[25] The NSW Inquiry proposed a series of such indicators, and suggested some indicative target values. See NSW Inquiry (2006), pp.272-274.

In this context, consideration should be given to targeting a balanced budget along the lines of section 100 of the NZ *Local Government Act 2002*, namely that a council's annual income (excluding capital grants) in any financial year must be set at a level that covers all expenses. Such a balanced-budget 'golden rule' would put at the top of councils' agenda the fostering of intergenerational equity, and so:

- ensure that each year's ratepayers meet the full cost (including depreciation) of that year's use of services and infrastructure; and
- provide for the maintenance and replacement of infrastructure assets.

Comparative financial KPIs should be provided on an estimates basis for the current year, actuals for the last three previous years, and projections for at least the coming three years based on continuation of current policies, allowing users to undertake meaningful analysis of the council's finances.

Finally, to encourage the acceptance and understanding of the key financial KPIs applying to councils, the WALGA (or the WA Department of Local Government and Regional Development) should sponsor the annual publication of a compilation and analysis of the comparative financial position and performance of WA councils, perhaps along the lines of the NSW Department of Local Government's annual *Comparative Information on NSW Local Government Councils* publication.

6.5 KEY CONCLUSIONS

That there are shortcomings in existing financial governance policies and practices of WA councils – as well as shortfalls in the level and escalation of tax sharing grants from other governments and any past cost shifting – is clear from the chronic operating deficits and mounting infrastructure backlogs that have been documented in this report.

The deficient policies and practices evident across local government in Australia at present include those relating to the under-funding of depreciation, the outdated measurement of asset values and depreciation, poor asset management systems and policies, and the inadequate monitoring and reporting of a council's financial position and performance.

Where financial governance is not well developed in councils, it is not surprising that there is a lack of understanding on the community's part of the true costs of current infrastructure and service commitments.

Improving such policies and practices would not only prompt councils to do more to ensure their financial sustainability, but might also convince other governments that increasing grant funding to local government could after all be a prudent use of taxpayer funds.

APPENDIX A

FINANCIAL DATA SOURCES

This Appendix briefly explains the nature and source of the primary financial data used in our assessments.

The WA Local Government Grants Commission (WALGGC) provided us with access to its council financial data base.

The WALGGC data are based upon audited general purpose financial reports prepared in accordance with the accounting and financial reporting requirements which are embodied in the WA *Local Government Act* and the Australian Accounting Standards.

This data source provided a range of financial aggregates at the individual council level, particularly the items set out in Table A-1.

TABLE A-1: KEY FINANCIAL AGGREGATES

Income items	Expense items	Capital transactions	Asset items	Liabilities items
Rates revenue (general and specified area)	Operating costs[(a)]	Other Commonwealth grants – capital	Cash and deposits	Payables
Fees and charges	Interest expense	State grants - capital	Investments, loans and placements	Tax liability
Fines	Depreciation and amortisation	Contributions	Accounts receivable (net of provision for doubtful debts)	Deposits held
General purpose (FA) grants	Bad debts written off (not previously provided)	Asset acquisitions	Work in progress	Proceeds from advances
Local roads grants	Other expenses n.e.c.	Asset proceeds from sale	Stock on hand (inventories) (incl. land held for resale)	Borrowings
Other Commonwealth grants and subsidies - current		Donated assets	Equity investments	Provisions for employee entitlements (employee benefits)
State grants and subsidies - current		Capital revenue n.e.c.	Advances to the private sector (excludes equity)	Other provisions
Interest revenue		Total principal repayment expense	Advances to local government enterprises (excludes equity)	Other liabilities
Profit/loss on sale of assets			Property, plant and equipment	
Current revenue n.e.c.			Other assets	

[(a)] comprises employee expenses (superannuation, wages and salaries, other), materials and contracts, private works, utilities, insurance, local government enterprise expenses, current grant expenses, subsidy expenses, fringe benefits tax expenses, capital grant expenses, grants expenses: assets donated

WALGGC does not audit the data. WALGGC has pointed out that, while all care has been taken in the preparation of this data, differing interpretations by local government, reporting of figures in thousands and rounding to whole dollars can result in figures not being 100% accurate.

We have focussed on the financial years 2001-02 to 2004-05, which provides a four year period for analysis.

APPENDIX B

GROUPINGS OF WA COUNCILS

This Appendix briefly describes the groupings of councils used throughout this report.

We have followed the WALGA in allocating WA councils to the following groups: metropolitan councils, South West country cities and towns, agricultural shires with large towns, pastoral shires with large towns, agricultural shires without large towns and pastoral shires without large towns.

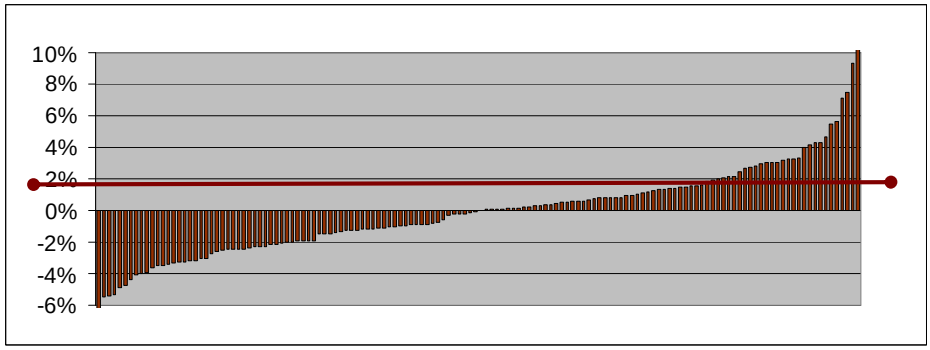
Rather than report our results for all six groups, we have confined our reporting to the following:

- metropolitan councils (29 councils in total);
- regional councils with large towns (comprising South West country cities and towns as well as both agricultural shires and pastoral shires with large towns) – 27 councils in total; and
- regional councils without large towns (comprising both agricultural shires and pastoral shires) – 86 councils in total.

Separately, we have reported our results for:

- based upon total operating expenses, the largest 25% of councils and the smallest 25% of councils (both 35 councils in total); and
- based upon the average annual rate of population growth evident over the last five years, above-average growth councils (29 councils) and declining growth councils (71 councils), with Chart B-1 showing there are significant differences among councils in the average annual rates of growth of their resident populations, which can have significant implications in any assessment of council finances.

CHART B-1: RELATIVE GROWTH OF COUNCIL, WA COUNCILS
ANNUAL POPULATION GROWTH RATE, 2000-01 TO 2004-05, PERCENTAGE POINTS



APPENDIX C

WA STATE GOVERNMENT: FINANCIAL RATIOS – 2004-05

WA Government, General Government Sector	2003-04 $ millions actual	2004-05 $ millions actual
FINANCIAL PERFORMANCE		
Operating grants from the Commonwealth	5,583	6,468
plus Operating grants from the State government	0	0
Operating grants from other governments	**5,583**	**6,468**
Tax revenue	4,776	5,155
plus Fees and charges	941	982
plus Other own-source operating revenue	1,030	1,128
Own-source revenues (before interest and realised gains on asset sales)	**6,747**	**7,265**
Total revenue (before capital amounts, interest and realised gains on asset sales)	**12,330**	**13,733**
Interest expense	448	449
less Interest income on unrestricted cash & securities	128	142
Net interest expense	**320**	**307**
% of total revenue	*2.6%*	*2.2%*
Operating expenses (before any realised losses on asset sales)	10,959	11,975
plus Depreciation expense	546	558
Other expenses (before any realised losses on asset sales)	**11,505**	**12,533**
Total expenses (net of interest income)	**11,825**	**12,840**
Operating surplus/(deficit) before capital amounts (and realised gains/losses on asset sales)	**505**	**893**
% of own-source revenue	*7.5%*	*12.3%*
Acquisition of non-financial assets	941	1,174
less Depreciation expense	546	558
less Capital receipts		
Carrying amount of non-financial assets sold	315	441
plus Net gain/(loss) from the disposal of non-financial assets	-149	-188
plus Capital grants from other governments	295	347
Net acquisition non-financial of assets	**-66**	**16**
% of capex on acquisition of non-financial assets	*-7.0%*	*1.4%*
Net borrowing/(lending)	**-571**	**-877**
% of total capital employed	*-1.8%*	*-2.4%*
FINANCIAL POSITION		
Non-financial assets	31,704	36,241
plus Other capital employed	426	542
Total capital employed	**32,130**	**36,783**
Interest bearing liabilities (includes superannuation liabilities)	8,167	7,835
less Cash & securities unrestricted	2,969	3,200
Net debt	**5,198**	**4,635**
% of total revenue	*42.2%*	*33.8%*
Provisions	1,344	1,390
plus Other liabilities (nei)	606	711
less Other investments	926	1,071
Other net liabilities	**1,024**	**1,030**
Net financial liabilities/(worth)	**6,222**	**5,665**
% of total capital employed	*19.4%*	*15.4%*
Net worth	**25,908**	**31,118**

Source: WA Treasury, *Government Financial Results Report 2004-05*, September 2005

APPENDIX D

FINANCIAL POSITION AND PERFORMANCE: SUMMARY TABLES

This Appendix provides summaries of the data used in this report regarding the financial position and performance of WA councils, for the years 2001-02 to 2004-05.

The following Tables are provided:

- Table D-1: All WA councils
- Table D-2: WA metropolitan councils
- Table D-3: WA regional councils with large towns
- Table D-4: WA regional councils without large towns

The format we have chosen for these Tables is useful for analytical purposes. The presentation is not intended as a substitute for the presentations required for financial reporting purposes either under Australian Accounting Standards or by the ABS's system of government finance statistics.

TABLE D-1: FINANCIAL POSITION AND PERFORMANCE, 2001-02 TO 2004-05
ALL WA COUNCILS (142 COUNCILS IN TOTAL)

All WA Councils	2001-02 $ millions actual	2002-03 $ millions actual	2003-04 $ millions actual	2004-05 $ millions actual
FINANCIAL PERFORMANCE				
Operating grants from the Commonwealth	196.3	194.0	224.2	221.1
plus Operating grants from the State government	62.0	74.0	66.3	66.5
Operating grants from other governments	**258.3**	**268.0**	**290.5**	**287.6**
Rates revenue	722.6	751.5	807.9	869.7
plus Fees and charges	317.4	371.5	394.8	434.3
plus Other own-source operating revenue	75.2	104.9	104.9	110.8
Own-source revenues (before interest and realised gains on asset sales)	**1,115.3**	**1,227.9**	**1,307.6**	**1,414.8**
Total revenue (before capital amounts, interest and realised gains on asset sales)	**1,373.6**	**1,495.9**	**1,598.2**	**1,702.5**
annual % increase		*8.9%*	*6.8%*	*6.5%*
Interest expense	13.6	18.7	13.0	17.1
less Interest income on unrestricted cash & securities	20.6	24.1	28.8	36.5
Net interest expense	**-7.0**	**-5.4**	**-15.8**	**-19.4**
% of total revenue	*-0.5%*	*-0.4%*	*-1.0%*	*-1.1%*
Operating expenses (before any realised losses on asset sales)	1,141.2	1,192.5	1,274.3	1,335.8
plus Depreciation expense	376.1	415.5	419.6	450.3
Other expenses (before any realised losses on asset sales)	**1,517.3**	**1,608.0**	**1,694.0**	**1,786.0**
Total expenses (before any realised losses on asset sales, and net of interest income)	**1,510.3**	**1,602.6**	**1,678.2**	**1,766.7**
annual % increase		*6.1%*	*4.7%*	*5.3%*
Operating surplus/(deficit) before capital amounts (and realised gains/losses on ass	**-136.7**	**-106.6**	**-80.0**	**-64.2**
% of own-source revenue	*-12.3%*	*-8.7%*	*-6.1%*	*-4.5%*
Capital expenditure on renewal/replacement of existing assets	335.4	313.0	339.7	342.8
less Status quo renewals capex	406.9	399.8	437.7	453.4
Net acquisition of existing non-financial assets	**-71.4**	**-86.8**	**-97.9**	**-110.6**
Actual renewals capex as % of status quo renewals capex	*82.4%*	*78.3%*	*77.6%*	*75.6%*
Acquisition of new and upgraded assets	173.6	194.5	262.4	360.6
less Capital receipts				
Carrying amount of non-financial assets sold	189.3	59.2	85.9	81.2
plus Net gain/(loss) from the disposal of non-financial assets	-14.4	13.7	16.5	13.9
plus Capital grants from other governments	122.6	111.4	116.4	147.8
plus Capital contributions	34.4	12.0	26.5	55.5
plus Other capital receipts (net)	-22.7	90.3	3.8	8.3
Net acquisition of new and upgraded assets	**-135.6**	**-92.1**	**13.2**	**53.9**
% of capex on new/upgraded assets	*-78.1%*	*-47.3%*	*5.0%*	*15.0%*
Net borrowing/(lending)	**-70.3**	**-72.3**	**-4.7**	**7.5**
% of net increase in capital employed (excluding valuation effects)	*-100.0%*	*-117.9%*	*-2.5%*	*2.7%*
FINANCIAL POSITION				
Non-financial assets	11,045.5	11,139.3	11,808.2	12,347.6
plus Working capital (including cash & securities restricted)	303.5	350.5	397.3	433.1
Total capital employed	**11,349.0**	**11,489.8**	**12,205.5**	**12,780.7**
Interest bearing liabilities	232.7	240.7	282.7	332.7
less Cash & securities unrestricted	308.0	387.2	440.7	505.4
Net debt	**-75.3**	**-146.5**	**-157.9**	**-172.7**
% of total revenue	*-5.5%*	*-9.8%*	*-9.9%*	*-10.1%*
Provisions	86.0	112.8	133.5	152.6
plus Other liabilities (nei)	37.6	59.3	18.9	37.8
less Other investments	1.5	51.1	24.6	40.2
Other net liabilities	**122.2**	**121.1**	**127.9**	**150.1**
Net financial liabilities/(worth)	**46.8**	**-25.4**	**-30.1**	**-22.6**
% of total capital employed	*0.4%*	*-0.2%*	*-0.2%*	*-0.2%*
Net worth	**11,302.2**	**11,515.2**	**12,235.6**	**12,803.2**

TABLE D-2: FINANCIAL POSITION AND PERFORMANCE, 2001-02 TO 2004-05
WA METROPOLITAN COUNCILS (29 COUNCILS IN TOTAL)

Metropolitan councils	2001-02 $ millions actual	2002-03 $ millions actual	2003-04 $ millions actual	2004-05 $ millions actual
FINANCIAL PERFORMANCE				
Operating grants from the Commonwealth	57.3	55.5	62.8	62.1
plus Operating grants from the State government	25.1	30.7	32.9	32.4
Operating grants from other governments	**82.4**	**86.2**	**95.7**	**94.5**
Rates revenue	486.8	508.7	540.1	581.4
plus Fees and charges	205.6	251.6	260.2	281.7
plus Other own-source operating revenue	45.7	62.4	58.5	64.8
Own-source revenues (before interest and realised gains on asset sales)	**738.2**	**822.7**	**858.9**	**927.9**
Total revenue (before capital amounts, interest and realised gains on asset sales)	**820.6**	**908.9**	**954.6**	**1,022.4**
annual % increase		*10.8%*	*5.0%*	*7.1%*
Interest expense	4.6	4.5	2.9	6.9
less Interest income on unrestricted cash & securities	14.7	17.8	20.9	26.4
Net interest expense	**-10.0**	**-13.3**	**-18.0**	**-19.5**
% of total revenue	*-1.2%*	*-1.5%*	*-1.9%*	*-1.9%*
Operating expenses (before any realised losses on asset sales)	684.5	731.6	778.3	807.3
plus Depreciation expense	181.2	198.1	201.4	222.2
Other expenses (before any realised losses on asset sales)	**865.7**	**929.7**	**979.6**	**1,029.5**
Total expenses (before any realised losses on asset sales, and net of interest income)	**855.7**	**916.4**	**961.6**	**1,010.1**
annual % increase		*7.1%*	*4.9%*	*5.0%*
Operating surplus/(deficit) before capital amounts (and realised gains/losses on ass	**-35.1**	**-7.4**	**-7.0**	**12.3**
% of own-source revenue	*-4.8%*	*-0.9%*	*-0.8%*	*1.3%*
Capital expenditure on renewal/replacement of existing assets	161.2	134.5	164.8	166.7
less Status quo renewals capex	167.0	143.9	179.3	185.7
Net acquisition of existing non-financial assets	**-5.8**	**-9.3**	**-14.5**	**-19.0**
Actual renewals capex as % of status quo renewals capex	*96.5%*	*93.5%*	*91.9%*	*89.8%*
Acquisition of new and upgraded assets	73.4	155.7	127.2	220.3
less Capital receipts				
Carrying amount of non-financial assets sold	70.2	29.0	41.4	41.4
plus Net gain/(loss) from the disposal of non-financial assets	-19.6	5.2	5.4	5.4
plus Capital grants from other governments	41.1	43.1	41.5	43.9
plus Capital contributions	14.5	5.1	16.4	34.5
plus Other capital receipts (net)	18.2	124.8	39.1	44.4
Net acquisition of new and upgraded assets	**-51.0**	**-52.5**	**-16.6**	**50.7**
% of capex on new/upgraded assets	*-69.5%*	*-33.7%*	*-13.0%*	*23.0%*
Net borrowing/(lending)	**-21.7**	**-54.4**	**-24.2**	**19.4**
% of net increase in capital employed (excluding valuation effects)	*-102.6%*	*-68.0%*	*-22.6%*	*9.7%*
FINANCIAL POSITION				
Non-financial assets	5,312.1	5,414.7	5,650.3	5,983.2
plus Working capital (including cash & securities restricted)	198.7	224.9	247.3	254.1
Total capital employed	**5,510.8**	**5,639.6**	**5,897.6**	**6,237.3**
Interest bearing liabilities	82.4	82.9	111.3	150.3
less Cash & securities unrestricted	215.3	276.8	315.0	351.6
Net debt	**-133.0**	**-194.0**	**-203.8**	**-201.3**
% of total revenue	*-16.2%*	*-21.3%*	*-21.3%*	*-19.7%*
Provisions	53.7	57.2	91.8	91.1
plus Other liabilities (nei)	37.2	53.4	14.9	32.8
less Other investments	0.2	13.3	23.8	24.1
Other net liabilities	**90.7**	**97.2**	**82.9**	**99.8**
Net financial liabilities/(worth)	**-42.3**	**-96.7**	**-120.9**	**-101.5**
% of total capital employed	*-0.8%*	*-1.7%*	*-2.0%*	*-1.6%*
Net worth	**5,553.1**	**5,736.3**	**6,018.5**	**6,338.8**

TABLE D-3: FINANCIAL POSITION AND PERFORMANCE, 2001-02 TO 2004-05
WA REGIONAL COUNCILS WITH LARGE TOWNS (27 COUNCILS IN TOTAL)

Regional councils with large towns	2001-02 $ millions actual	2002-03 $ millions actual	2003-04 $ millions actual	2004-05 $ millions actual
FINANCIAL PERFORMANCE				
Operating grants from the Commonwealth	56.7	55.8	63.8	62.4
plus Operating grants from the State government	15.9	23.8	15.3	18.2
Operating grants from other governments	**72.6**	**79.6**	**79.1**	**80.5**
Rates revenue	150.0	154.0	170.7	185.1
plus Fees and charges	72.1	82.5	95.5	109.8
plus Other own-source operating revenue	18.5	27.3	26.5	27.1
Own-source revenues (before interest and realised gains on asset sales)	**240.6**	**263.8**	**292.7**	**322.1**
Total revenue (before capital amounts, interest and realised gains on asset sales)	**313.2**	**343.5**	**371.8**	**402.6**
annual % increase		*9.7%*	*8.2%*	*8.3%*
Interest expense	6.2	11.3	6.5	7.1
less Interest income on unrestricted cash & securities	3.8	4.0	5.1	6.6
Net interest expense	**2.4**	**7.3**	**1.3**	**0.5**
% of total revenue	*0.8%*	*2.1%*	*0.4%*	*0.1%*
Operating expenses (before any realised losses on asset sales)	262.1	277.5	300.6	318.7
plus Depreciation expense	99.9	114.5	115.9	122.0
Other expenses (before any realised losses on asset sales)	**362.0**	**392.1**	**416.5**	**440.7**
Total expenses (before any realised losses on asset sales, and net of interest income)	**364.4**	**399.3**	**417.8**	**441.1**
annual % increase		*9.6%*	*4.6%*	*5.6%*
Operating surplus/(deficit) before capital amounts (and realised gains/losses on ass	**-51.2**	**-55.9**	**-46.1**	**-38.5**
% of own-source revenue	*-21.3%*	*-21.2%*	*-15.7%*	*-12.0%*
Capital expenditure on renewal/replacement of existing assets	76.7	79.5	71.6	71.8
less Status quo renewals capex	90.0	102.8	92.0	94.8
Net acquisition of existing non-financial assets	**-13.3**	**-23.3**	**-20.4**	**-23.0**
Actual renewals capex as % of status quo renewals capex	*85.3%*	*77.3%*	*77.8%*	*75.7%*
Acquisition of new and upgraded assets	58.0	32.7	60.2	93.7
less Capital receipts				
Carrying amount of non-financial assets sold	40.1	10.7	17.8	17.2
plus Net gain/(loss) from the disposal of non-financial assets	4.9	4.6	7.7	4.9
plus Capital grants from other governments	33.8	30.3	31.8	49.9
plus Capital contributions	12.7	2.2	4.8	8.2
plus Other capital receipts (net)	13.2	14.4	26.7	27.7
Net acquisition of new and upgraded assets	**-46.8**	**-29.5**	**-28.5**	**-14.3**
% of capex on new/upgraded assets	*-80.7%*	*-90.4%*	*-47.4%*	*-15.2%*
Net borrowing/(lending)	**-8.9**	**3.1**	**-2.9**	**1.3**
% of net increase in capital employed (excluding valuation effects)	*-258.2%*	*-100.0%*	*-12.8%*	*2.7%*
FINANCIAL POSITION				
Non-financial assets	2,738.9	2,695.5	2,906.6	2,964.2
plus Working capital (including cash & securities restricted)	57.2	61.7	87.5	112.1
Total capital employed	**2,796.1**	**2,757.2**	**2,994.1**	**3,076.3**
Interest bearing liabilities	102.1	107.5	118.5	122.3
less Cash & securities unrestricted	53.7	63.3	78.2	99.9
Net debt	**48.4**	**44.2**	**40.3**	**22.4**
% of total revenue	*15.5%*	*12.9%*	*10.8%*	*5.6%*
Provisions	19.2	22.0	25.2	45.2
plus Other liabilities (nei)	0.9	5.6	3.3	4.1
less Other investments	0.0	0.2	0.1	1.7
Other net liabilities	**20.1**	**27.3**	**28.4**	**47.6**
Net financial liabilities/(worth)	**68.5**	**71.6**	**68.7**	**70.0**
% of total capital employed	*2.5%*	*2.6%*	*2.3%*	*2.3%*
Net worth	**2,727.5**	**2,685.6**	**2,925.4**	**3,006.3**

TABLE D-4: FINANCIAL POSITION AND PERFORMANCE, 2001-02 TO 2004-05
WA REGIONAL COUNCILS WITHOUT LARGE TOWNS (86 COUNCILS IN TOTAL)

Regional councils without large towns	2001-02 $ millions actual	2002-03 $ millions actual	2003-04 $ millions actual	2004-05 $ millions actual
FINANCIAL PERFORMANCE				
Operating grants from the Commonwealth	82.4	82.7	97.6	96.6
plus Operating grants from the State government	21.0	19.4	18.1	16.0
Operating grants from other governments	**103.4**	**102.1**	**115.7**	**112.6**
Rates revenue	85.8	88.8	97.1	103.1
plus Fees and charges	39.7	37.4	39.1	42.8
plus Other own-source operating revenue	11.0	15.2	19.9	18.9
Own-source revenues (before interest and realised gains on asset sales)	**136.5**	**141.4**	**156.1**	**164.9**
Total revenue (before capital amounts, interest and realised gains on asset sales)	**239.9**	**243.6**	**271.8**	**277.5**
annual % increase		*1.5%*	*11.6%*	*2.1%*
Interest expense	2.7	2.9	3.6	3.1
less Interest income on unrestricted cash & securities	2.1	2.3	2.7	3.5
Net interest expense	**0.7**	**0.6**	**0.9**	**-0.4**
% of total revenue	*0.3%*	*0.2%*	*0.3%*	*-0.1%*
Operating expenses (before any realised losses on asset sales)	194.6	183.4	195.5	209.8
plus Depreciation expense	95.0	102.9	102.3	106.0
Other expenses (before any realised losses on asset sales)	**289.5**	**286.2**	**297.8**	**315.8**
Total expenses (before any realised losses on asset sales, and net of interest income)	**290.2**	**286.8**	**298.8**	**315.5**
annual % increase		*-1.2%*	*4.2%*	*5.6%*
Operating surplus/(deficit) before capital amounts (and realised gains/losses on ass	**-50.3**	**-43.3**	**-27.0**	**-38.0**
% of own-source revenue	*-36.9%*	*-30.6%*	*-17.3%*	*-23.0%*
Capital expenditure on renewal/replacement of existing assets	97.5	99.0	103.4	104.4
less Status quo renewals capex	149.9	153.2	166.3	172.9
Net acquisition of existing non-financial assets	**-52.3**	**-54.2**	**-63.0**	**-68.5**
Actual renewals capex as % of status quo renewals capex	*65.1%*	*64.6%*	*62.1%*	*60.4%*
Acquisition of new and upgraded assets	42.2	6.2	75.0	46.5
less Capital receipts				
Carrying amount of non-financial assets sold	79.0	19.5	26.7	22.5
plus Net gain/(loss) from the disposal of non-financial assets	0.3	2.9	3.5	3.6
plus Capital grants from other governments	47.7	38.1	43.1	54.0
plus Capital contributions	7.1	4.6	5.3	12.8
plus Other capital receipts (net)	-54.1	-48.8	-62.0	-63.8
Net acquisition of new and upgraded assets	**-37.7**	**-10.0**	**58.4**	**17.4**
% of capex on new/upgraded assets	*-89.4%*	*-161.4%*	*77.9%*	*37.5%*
Net borrowing/(lending)	**-39.7**	**-20.9**	**22.4**	**-13.1**
% of net increase in capital employed (excluding valuation effects)	*-100.0%*	*-100.0%*	*39.5%*	*-50.1%*
FINANCIAL POSITION				
Non-financial assets	2,994.5	3,029.1	3,251.3	3,400.2
plus Working capital (including cash & securities restricted)	47.7	63.9	62.5	66.9
Total capital employed	**3,042.2**	**3,093.0**	**3,313.8**	**3,467.0**
Interest bearing liabilities	48.3	50.3	53.0	60.1
less Cash & securities unrestricted	39.0	47.1	47.5	53.9
Net debt	**9.2**	**3.2**	**5.5**	**6.2**
% of total revenue	*3.8%*	*1.3%*	*2.0%*	*2.2%*
Provisions	13.2	33.6	16.5	16.3
plus Other liabilities (nei)	-0.4	0.4	0.7	0.8
less Other investments	1.3	37.5	0.7	14.4
Other net liabilities	**11.4**	**-3.5**	**16.6**	**2.7**
Net financial liabilities/(worth)	**20.7**	**-0.3**	**22.1**	**8.9**
% of total capital employed	*0.7%*	*0.0%*	*0.7%*	*0.3%*
Net worth	**3,021.5**	**3,093.3**	**3,291.7**	**3,458.1**

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