Chairperson and Committee Members
AUDIT AND RISK SUBCOMMITTEE

19 JUNE 2014

Meeting Status: **Public**

Purpose of Report: For Information

FINANCIAL PRUDENCE REGULATIONS

PURPOSE OF REPORT

1 To update the Audit & Risk Subcommittee on the recently introduced Department of Internal Affairs' (DIA) Local Government Financial Prudence Regulations and the Office of the Auditor General's (OAG) financial indicators.

SIGNIFICANCE OF DECISION

2 This report does not trigger Council's Significance Policy.

BACKGROUND

Local Government Financial Prudence Regulations

3 As part of the government's ongoing local government reforms, 'the Better Local Government' reform programme was created to provide better clarity about councils' roles, stronger governance, improved efficiency and more responsible fiscal management. It is an eight point reform programme to improve the legislative framework for local authorities.

4 One of the reforms addresses the issue of fiscal responsibility, or financial prudence. On November 2013, new financial prudence regulations were announced to tighten financial reporting, lift transparency and encourage excellence in local government.

5 The regulations are intended to provide a standardised way of financial reporting to encourage council efficiency and improve accountability to ratepayers. From 2014 onwards, all councils have to report against a set of benchmarks around three key elements of financial prudence – affordability, sustainability and predictability.

6 Affordability will be measured through rates and debt information, sustainability through a balanced budget, expenditure on essential services, and debt servicing and predictability through cash flow from operations and debt control information.

7 There are seven benchmark measures of financial prudence, and these are to be complemented by two measures of affordability. The measures are:

	Benchmark	Benchmark Met If:	Rationale
AFFORDABILITY	**Rates affordability benchmark**	Actual or planned rates income for the year equals or is less than each quantified limit on rates; ***and*** Actual or planned rates increases for the year equal or are less than each quantified limit on rates increases.	The affordability benchmarks are intended to help assess the affordability to present & future ratepayers of Councils expenditure & financing activities.
	Debt affordability benchmark	Actual or planned borrowing for the year is within each quantified limit on borrowing.	The affordability benchmarks are intended to help assess the affordability to present & future ratepayers of Councils expenditure & financing activities.
SUSTAINABILITY	**Balanced budget benchmark**	Revenue (excl development & financial contributions, revaluations of PP&E, gains on derivative financial instruments & vested assets) exceeds operating expenses (excl losses on derivative financial instruments & revaluations of PP&E).	Intended to discourage short-sighted decisions which keep rates low by allowing debt to increase to excessive levels. The balanced budget benchmark will make it transparent if the Council is using debt to fund operating expenses.
	Essential services benchmark	Capital expenditure on network services equals or is greater than depreciation on network services for the year.	Intended to discourage short-sighted decisions which keep rates low by neglecting necessary investment in network infrastructure. Designed to identify where network infrastructure is being allowed to run down.
	Debt servicing benchmark	Borrowing costs for the year equal or are less than 10% of its revenue (excl development contributions, financial contributions, vested assets, gains on derivative financial instruments and revaluations of PP&E) for the year. However, a high-growth local authority meet the debt servicing benchmark for a year if its borrowing costs for the year equal or are less than 15% of its revenue (excluding development contributions, financial contributions, vested assets, gains on derivative financial instruments and revaluation of PP&E) for the year.	This compares interest expense with revenue. A high level of debt servicing indicates little flexibility to undertake unplanned capital investment & is vulnerable to increases in interest rates.

PREDICTABILITY	**Debt control benchmark**	Actual net debt at the end of the year is less than or equal to the net debt planned for the end of the year in its long term plan.	Intended to identify where poor cost control creates risks to the containment of rate & debt increases. Debt being greater than projected is an indicator of weak capital expenditure control.
	Operations control benchmark	Actual net cash flow from operations for the year equals or is greater than its planned net cash flow from operations for the year.	Intended to identify where poor cost control creates risks to the containment of rate & debt increases. This benchmark highlights where operating cash flows may be poorly managed.

8 Council is required to report on these measures in its 2013/14 Annual Report, which will be published by the end of October this year. Council must report on actual performance against benchmarks for the current year; and for the previous four years. There is a transition allowed initially, with a minimum of one year to be reported (but further back if possible).

9 Disclosure is also required of the number of rating units, and the rateable capital value and land value. Going forward this information will be required in Long Term Plans, Annual Plans, and Annual Reports.

10 The DIA is going to report on two further benchmark measures, using published data:

- Rates per rating unit
- Net debt per rating unit

11 The Minister proposed a dashboard presentation of the results for all councils, but without attempting to rank councils as a result. Councils could be grouped according to characteristics such as population size, density, growth and household income. The presentation would have traffic lights, but these would not be adopted until 2 rounds of reporting were complete.

12 Points to note:

- Rates revenue will include water meters.
- Net debt is limited to the inclusion of financial assets (cash, investments that are paid in cash and equity in companies). The likes of forestry and property assets are therefore excluded.

<u>OAG Financial Indicators</u>

13 The 2012 round of local authorities' long-term plans coincided with the Better Local Government reform. At the heart of the 2012-22 long-term plans was local authorities' response to the new requirement to be clear on their financial strategy. A good financial strategy allows local communities to better assess the prudence and long-term financial sustainability of local authorities' plans.

14 The OAG considers that views on what constitutes prudence and long-term financial sustainability differ and there are few agreed methods of analysis. As a result, it is difficult to be definitive about the state of an individual local authority or of local authorities as a whole. Without a general consensus, the OAG used nine specific indicators to help to describe local authorities' financial prudence. The OAG uses financial statements to help assess the aggregate effect on three aspects of a local authority's ability to deliver on its objectives. These three areas are:

14.1 The stability of a local authorities activities is about how reliable an entity is in planning, budgeting and delivering services (comparing actual performance with budget / forecast);

14.2 The resilience of a local authority to short term unanticipated events reflects how well the entity can “bounce back” without major structural or organisational change (look at fixed costs, interest payable & surplus / deficit in cash flow statement & income statement);

14.3 The sustainability of a local authority looks at how prepared an entity is for long-term uncertainties & to maintain itself indefinitely (focus on assets, liabilities & debt together with related items such as capital expenditure & expenditure on asset renewal).

15 **Indicators by Assessment Category**

Stability	**Resilience**	**Sustainability**
Actual to budgeted net cash flows from operations	Interest expense to debt	Capital expenditure to depreciation
Actual to budgeted debt	Interest expense to rates revenue	Renewals expenditure to depreciation
Actual to budgeted capital expenditure	Fixed costs to operating and investing cash outflows	Gross debt to total assets

16 For stability, actual net cash flows from operations, debt levels and capital expenditure are compared with what was originally budgeted. A result of 100% indicates reliable planning, accurate budgeting and robust delivery.

17 There are three resilience indicators. A high interest to debt indicator indicates less flexibility in responding to unexpected events and can also indicate a higher perceived risk of repayment. The interest to rates indicator shows the proportion of rates revenue that relates to the interest cost of debt and a higher percentage means less flexibility and fewer available resources in responding to unexpected events. The fixed costs to operating and investing cash outflows indicator shows the proportion of operating and investing flows that are not able to adjust to changing times. The higher the percentage, the less flexibility to respond to unexpected events.

18 For sustainability indicators, capital expenditure is related to depreciation on the basis that depreciation is a reasonable estimate of the capital expenditure needed to maintain the existing asset base. 100% indicates sustainability while higher indicates spending on new assets as well. The indicator of renewals expenditure to depreciation assumes that depreciation is a reasonable estimate of the capital expenditure needed to maintain the existing asset base. 100% usually indicates sustainability. The final indicator looks at the proportion of gross debt to total assets which indicates capability to manage longer term financial uncertainties. It also looks at the level of debt as a source of funding assets.

CONSIDERATIONS

Performance against the DIA Financial Prudence Regulations

19 The following table shows how Kāpiti Coast District Council fares against the benchmarks for last financial year (12/13) and for next year's DAP.

Kāpiti District Council
Financial Prudence Benchmarks

	LTP 12/13 $000	Actual 12/13 $000		LTP 14/15 $000	AP 14/15 $000	
Rates affordability benchmark			NOT MET			MET
Rates income	47,180	48,524		54,566	52,919	
Actual rates income is less than quantified limit						
Rates Increase	5.90%	5.90%		6.80%	4.95%	
Actual rates increase less than quantified limit						
Debt affordability benchmark			MET			MET
Public debt	135,190	125,224		156,053	144,403	
Actual borrowing is within quantified limit						
Balanced budget benchmark			MET			MET
Rates		48,524			52,919	
Other revenue		9,009			11,355	
Operating revenue		57,533			64,274	
Operating expenditure		-40,676			-44,829	
Revenue > operating expenses		**16,857**			**19,445**	
Revenue exceeds operating expenses						
Essential services benchmark			MET			MET
Capital expenditure		20,297			20,297	
Depreciation		9,773			9,773	
Capex > depreciation		**10,524**			**10,524**	
Capex on network services is greater than depreciation for the year						
Debt servicing benchmark			NOT MET			NOT MET
Borrowing costs		6,323			8,454	
Operating revenue		57,533			64,274	
Borrowing costs/operating revenue		**11.0%**			**13.2%**	
This should be equal or less than 10% of revenue (Kapiti growth 0.7%, NZ growth 0.9%)						
Debt control benchmark			MET			MET
Net debt	131,629	117,564		152,056	140,419	
Actual < LTP						
Actual net debt is less than LTP planned debt						
Operations control benchmark			NOT MET			NOT MET
Net cash flow from operations	12,451	11,657		14,714	13,547	
Actual < LTP						

20 Council is on target to meet five out of seven of the benchmark measures in its 2014/15 Annual Plan. The two measures that it is not on target to meet are the Debt Servicing benchmark and the Operations Control benchmark. Not meeting the debt servicing benchmark is indicative of Council's debt levels.

<u>Performance against the OAG Financial Indicators</u>

21 The table below shows Council's indicators compared with the averages that came out of the review of Local Authority LTP's by the OAG. This is based on Council's results for the year ended 30 June 2013.

<u>Financial Indicators used by OAG</u> *OAG averages based on their review of Local Authority LTPs*	**Council** **2012/13**	**OAG Average**
Stability		
Actual to budgeted net cash flows from operations	93.6%	95.0%
Actual to budgeted debt	92.6%	90.0%
Actual to budgeted capital expenditure	80.0%	81.0%
Resilience		
Interest expense to debt	5.0%	5.9%
Interest expense to rates revenue	13.0%	9.0%
Fixed costs to operating and investing cash outflows	40.4%	37.0%
Sustainability		
Capital expenditure to depreciation	318.6%	135.0%
Renewals expenditure to depreciation	57.2%	75.0%
Gross debt to total assets	14.3%	6.0%

22 Council is close to the average for the stability indicators. The same applies to the resilience indicators except for interest expense to rates revenue where Council is 13% against an average of 9%. This is an indicator of Council's high debt levels.

23 With the sustainability indicators Council is well outside the averages. Capital expenditure to depreciation is a reflection of the high levels of capital expenditure in the year. Renewals expenditure is lower which probably reflects the newer infrastructure in Kāpiti not yet needing to be replaced. Gross debt to total assets is high but again reflects the high level of debt in Kāpiti.

Financial Considerations

24 There are no financial considerations.

Legal Considerations

25 There are no legal issues arising from the matters discussed in this report.

Delegation

26 The Audit and Risk Subcommittee may make a decision under the following delegation in the Governance Structure, Section C.4:
Without limiting the generality of this delegation the Subcommittee has the following functions, duties and powers:
Internal Control Framework
6.1 Review whether management's approach to maintaining an effective internal control framework is sound and effective.

Policy Implications

27 There are no policy implications.

Tāngata Whenua Considerations

28 There are no tāngata whenua considerations arising from this report.

Publicity Considerations

29 There are no publicity issues to be considered at this stage.

RECOMMENDATIONS

30 That the Audit & Risk Subcommittee notes the recently introduced Financial Prudence Regulations and the Office of the Auditor General's financial indicators.

Report prepared by:

Wayne Maxwell
Group Manager Corporate Services