CONTROLLER AND AUDITOR-GENERAL
New Zealand | Tumuaki o te Mana Arotake

Level 2, 100 Molesworth Street, Thorndon 6011
PO Box 3928, Wellington 6140, New Zealand

Email: john.ryan@oag.govt.nz
Telephone: +64 4 917 1500

Website: www.oag.govt.nz   www.audit.govt.nz

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John Ryan

Local government funding and financing inquiry
New Zealand Productivity Commission
PO Box 8036
The Terrace
Wellington 6143

Email: info@productivity.govt.nz

COMMENTS ON LOCAL GOVERNMENT FUNDING AND FINANCING ISSUES PAPER

The Productivity Commission has released an issues paper that will inform an inquiry into local government funding and financing. This letter provides written comments from the Office of the Auditor-General (the Office).

Our interest is in ensuring that councils can sustainably fund the delivery of services to their communities now and in the future. We have observed from our audit work that the provision of affordable and sustainable services to communities is becoming more challenging. The challenges faced by councils are not isolated to their own district or region. Individually, councils are grappling with issues that are affecting the entire country – for example, the effects of climate change. As a result, increased consideration needs to be given to the roles of central government versus local government in addressing these challenges. National problems require national solutions.

It is our view that there is a need to confirm the future role of local government before determining what an appropriate funding and financing model looks like. The issues paper notes that there are a number of reviews currently under way that might have an effect on the roles and responsibilities of the sector, including the Three Waters Review. The effects of these reviews need to be carefully considered in the Commission's inquiry.

We have highlighted the key trends we have observed from our work in the sector; in particular, our observations arising from our audits of councils' long-term plans (LTPs). We highlight those issues that we consider will have an effect on the ability of councils to sustainably fund the delivery of services to their communities in the future.

The Auditor-General's role in local government

The Auditor-General is responsible for auditing all local authorities, including the audit of their LTPs, and related public entities such as council-controlled organisations. The Auditor-General also has the discretion to carry out other work, including performance audits to consider matters of effectiveness and efficiency, probity, and waste; and inquiries into any matter relating to a local government entity's use of its resources. In exercising these functions, the Auditor-General does not comment on policy matters.

The challenges councils face

The issues paper captures well the challenges that councils face. New Zealand has a population that is increasing, ageing, and becoming more ethnically diverse. Communities are changing, as are their expectations of councils and government more generally. Those who use a council's services are not always those who live in that district or city, we have a more mobile workforce, and there has been a significant increase in tourism.

Many of the challenges faced by councils are local issues, which councils are best placed to consider and address. However national and international challenges, such as immigration and climate change, need to also be considered. We think it is more effective for national solutions to be developed for national issues.

For example, councils face growing costs in responding and adapting to climate change and natural hazard events. Clarity is needed around local and central government roles and responsibilities to address climate change issues, including who identifies the risks, who makes decisions for mitigation and adaptation, and who bears the costs.

Where national solutions are required or levels of service are set at a national level (for example, the quality of our drinking water), consideration needs to be given to who funds the cost of these national standards.

The future role of local government needs to be confirmed and understood before considering a funding and financing model

There are a number of reviews under way that could have a significant effect on the roles and responsibilities of local government; in particular, the Three Waters Review. Other potential regulatory reform will also play a part in determining roles and responsibilities across central and local government – for example, the Zero Carbon Bill from a risk and resilience perspective, and proposed changes to the Local Government Act 2002 to reintroduce the concept of well-beings.

The issues paper notes that these pieces of work provide useful context for the inquiry and they focus on specific aspects of the funding and financing system or on specific classes of infrastructure. However, for many councils, the provision of three waters is a significant component of the infrastructure they deliver. Careful consideration needs to be given to the individual and cumulative outcomes of these reviews when undertaking this inquiry.

Forecast council investment

We regularly report to Parliament on the findings, trends, and matters of concern arising from our annual audits and three-yearly LTP audits.

Our most recent report is *Matters arising from the audits of the 2018-28 long-term plans*, in which we discuss the trends we identified in the forecast financial information contained in the 2018-28 LTPs. A copy of this report is available on our website (https://oag.govt.nz/2019/ltps/docs/ltps.pdf).

Significant capital expenditure is forecast in the future

The Commission notes in the issues paper that capital expenditure is projected to decrease slightly from current levels. This is not the trend that we have identified from the 2018-28 LTPs. We identified that, collectively, councils are forecasting significant capital expenditure to be spent over the next 10 years. Councils propose to spend $54.5 billion over the next 10 years, which is 31% more than what they proposed in their 2015-25 LTPs. This trend is expected to continue (as outlined in the 30-year infrastructure strategies).

Our report *Matters arising from the audits of the 2018-28 long-term plans* includes the following table detailing forecast capital expenditure in the 2018-28 LTPs compared with the 2015-25 LTPs.

Capital expenditure	**2015-25 LTP $billion**	**2018-28 LTP $billion**	**% increase**
Meet additional demand	8.2	12.4	51
Improve the level of service	13.2	18.6	41
Renew existing assets	20.1	23.5	17
Total	**41.5**	**54.5**	**31**

Capital expenditure to meet additional demand is concentrated in councils that are responding to growth.

High-growth councils are starting to come up against their debt covenants

Consistent with the principle of inter-generational equity, many councils use debt to fund much of their capital expenditure. From our analysis of councils' 2018-28 LTPs, we found that councils are forecasting a sharp increase in expected debt to fund anticipated growth. Debt is forecast to increase 47% in the 2018-28 LTP forecasts to around $26 billion. This is $5.4 billion or 27% more than what councils forecast in their 2015-25 LTPs.

We have concerns that some "high-growth" councils are starting to come up against the debt limits that they have set. Councils nearing such limits run the risk that they will not be able to respond to unexpected events because their funding sources might be limited, or will not be able to transform their service delivery so that it is fit for the future.

Faced with this, councils are increasingly starting to consider using more innovative funding tools – for example, establishing "special purpose vehicles" to provide councils with alternative funding mechanisms. It is important for councils to understand the implications of these new initiatives so that we can be confident as a country that these are the most efficient and effective funding mechanism available in the circumstances.

We looked at the assumptions councils used to form their LTP financial forecasts. The assumption for forecast interest rates stood out. For 2018-28, the forecast interest expenditure is comparatively lower than in the 2015-25 LTPs because of anticipated lower interest rates. However, if interest rates increase more than anticipated, this could limit some councils' ability to service their debt and carry out their capital expenditure programmes without making other changes, such as increasing rates or reducing other expenditure.

Councils might not be sufficiently reinvesting in their assets

Most forecast capital expenditure in the 2018-28 LTPs is on renewing councils' assets (see the table above). This amount remains less than forecast depreciation, indicating that councils as a whole might not be adequately reinvesting in their assets. This gap is present for all of councils' core assets other than flood protection and control assets. If councils do not continue to renew and invest in their current infrastructure, they run an increased risk that critical infrastructure assets might fail. We have repeatedly raised these concerns in our previous reports.

In completing our analysis, we assumed that forecast depreciation is a reasonable estimate of how much an asset will be used up over its useful life. It is important to note that the assets owned by councils have a long life and that, while the depreciation on these assets is generally spread evenly over the life of the asset, renewals expenditure will not be incurred evenly over the life of the asset network.

We note that there could be one or more potential reasons for any renewals gap:

- Councils might not be spending what they need to on their assets to maintain them into the future. With councils' knowledge and information about the condition and performance of their assets needing improvement, councils might not know when they need to renew an asset and therefore not budget to do it at the right time.

- Councils might be appropriately deferring the renewal of assets because the asset will last for longer than expected. In this case, councils might need to confirm that they have adjusted their forecasts to reflect the later timing of the renewal expense and the asset's increased useful life (and therefore lower depreciation).

We have continued to report that councils need to investigate their own assets at a more detailed asset type and system level to identify whether there is a gap and the reasons for any renewals gap. We acknowledge that each council faces its own circumstances, given their different approaches to managing their assets and their unique renewals profile.

As part of our audits of the 2018-28 LTPs, we sought to understand what work councils had done to investigate their forecast renewals gap. We found that councils often noted in their 2018-28 LTPs that they have under-invested in assets in previous years, and that the majority of councils had done detailed work on the gap between forecast renewals and depreciation and have plans to manage their forecast renewals gap. These plans include putting in place funding sources (generally these are additional rates or increases to existing rates) to pay for the future renewals. Our view is that councils need to continue to review their plans to manage any renewals gap they face so the plans remain relevant and appropriate, particularly as they gain better knowledge about their assets.

We note that Question 2 in the issues paper asks:

> *What explains the difference between the amount that councils account for depreciation and the amount spent on renewing assets? Are changes needed to the methods councils use to estimate depreciation? If so, what changes are needed?*

We feel a better way of framing this question is to ask "Why is less renewal work being done than appears to be needed?" How Question 2 is framed implies there might be an issue with the method councils use to estimate depreciation. We do not believe the answer is as simple as this as indicated by our comments above.

Other observations

Councils need to gain a better understanding of the condition and performance of their assets

Councils are asset-intensive entities. The current state and performance of assets and the renewals profile of a council is relevant for understanding local government funding and financing issues. Historical decisions about the reinvestment in assets might contribute to the cost of services provided by councils in the future, and this in turn might have implications for how the cost is funded.

There is variability across councils on what they know about the condition and performance of their assets, and the approach to managing their assets.

We have continued to express concerns that councils do not have good enough information about the state of their assets. This might limit the understanding a council has about the future costs, and/or the ability of the council to meet future service levels (as demanded by communities or by standards set by central government).

In our 2017 report *Getting the right information to effectively manage public assets: Lessons from local authorities*, we noted:

> *Local authorities need to know which assets are the most important for delivering essential services. By identifying their most important assets, and directing resources towards gathering the right information about them, local authorities are better placed to make informed decisions about how to best manage those assets. A poor or incomplete understanding could lead to poor decisions with longer-term negative effects, including asset renewal planning that is not sustainable or achievable.*

We recommended in our report *Matters arising from the 2018-28 long-term plans* that councils prioritise collecting condition and performance information of critical assets and, in the meantime, take a precautionary approach for significant services where the condition information of critical assets is unknown. This is fundamental to supporting better management of assets to deliver services more efficiently and might better reflect the actual level of investment required.

Impacts of Treaty settlement arrangements

We note that the Commission has been asked to consider the impacts of Treaty settlement arrangements on local government. Co-governance and co-management arrangements have become more common. Although there are enduring benefits for Māori and communities, realising these can come at a cost for councils.

Over the last few years, the Office has actively considered examples of co-governance and co-management. We have found that the commitment required to establish relationships, to establish processes and to build and maintain a shared understanding of what everyone is trying to achieve is significant and is often underestimated. An underestimation of resources (both time and financial commitment) can undermine the effectiveness of the arrangements, resulting in more costs in the long run.

Rates-setting practices

Rates are the most significant income stream for most councils. If this is to continue, we think that it might be beneficial to consider the ways in which rates are set and collected to gain assurance that the current system is not unnecessarily complex. In our previous work,[1] we have noted that many councils had problems with rating compliance. This can create risks to a council's revenue.

Concluding comments

Thank you for the opportunity to provide comments. We would be happy to meet with you to discuss them, and look forward to continuing to engage with the Commission as this work progresses.

Yours sincerely

John Ryan
Controller and Auditor-General

[1] For example, *Local government: Results of the 2012/13 audits* (2014) and *Local government: Results of the 2016/17 audits* (2018).