Report: State of Victorian Local Government Finances

October 2022

MUNICIPAL ASSOCIATION OF VICTORIA

Local Government Finance Professionals

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Executive summary

This report provides an analysis of the actual financial results from 2016-17 to 2020-21, projected financial results from 2021-22 to 2025-26 and consideration of the emerging sustainability gap for Victoria local governments. The three areas found to be contributing to the sustainability gap were:

- Rate cap is less than changes in the local government cost base
- Asset renewal is less than depreciation
- Unrestricted cash is diminishing.

The rate cap is not representative of changes in the local government cost base. As pressure continues to grow on the operating costs of the sector due to inflationary pressures, expected growth in wages and post COVID-19 structural changes, the gap between the rate cap and changes in the cost base will only widen over time. To remain viable over the long term, Councils will need to reduce services and/or capital works.

Councils are not funding their asset renewal needs which will result in higher maintenance costs, lower asset service standards and the potential for asset failure. As funds are redirected to address the imbalance between the local government cost base increases and the rate cap, the asset renewal gap will only continue to grow (2016-21: asset renewal gap of $1.9 billion).

Councils have reasonably strong balance sheets but as unrestricted cash declines, discretionary expenditure will also decline. This will leave councils with limited capacity to invest in services and infrastructure to meet the needs and aspirations of its communities. Councils have relatively low levels of debt so new infrastructure can be funded from debt in the medium term. However, debt is not a finite funding source and with interest rates expected to continue rising to address inflationary pressures, debt servicing costs will also rise and compete for funding.

Based on actual financial performance from 2016-17 to 2020-21, its evident that Councils have remained viable by reducing investment in asset renewal expenditure relative to depreciation. With CPI currently sitting at 6.1% for the 12 months to June 2022, the revised 2022-2031 financial plans are expected to show underlying deficits over the long term as the gap between the rate cap and cost base increases, widen. This will be exacerbated as enterprise agreements are renegotiated and predicted wage growth impacts flow through to the cost base. A Victorian local government cost index is required to ensure that the rate cap is properly based.

1. Background

1.1 Purpose of report

In Victoria, following an inquiry conducted by the Essential Services Commission (ESC) in 2015, the Victorian State Government resolved to impose rate capping commencing on 1 July 2016, for the 2016-17 financial year. Since that time the Minister for Local Government has determined the rate cap for each financial year based on a recommendation by the ESC. In its 2019 report for the 2016-17 to 2017-18 years (the first two years of the cap) the ESC found that growth in the sector's total rate per property revenue reduced from an average of 5.1 per cent per annum in the three years prior to the introduction of rate capping, to 2.4 per cent in 2016–17 and 1.9 per cent in 2017–18. For the 2021-22 year the cap is 1.5%.

While the rate capping impacts on rates raised has been immediate since its inception, the ability of councils to respond with offsetting reductions in expenditure has been much slower due to the time required to undertake structural reviews and realise savings. This has put pressure on council capital works programs to balance the books in the short to medium term. Councils have also had to respond to the ongoing impacts of cost shifting and more recently the loss of revenue from COVID-19 shutdowns.

This report provides an analysis of the actual financial results from 2016-17 to 2020-21, projected financial results from 2021-22 to 2025-26 and consideration of the emerging sustainability gap based on these results.

1.2 Data used and sources

The following data sources have been used in the preparation of this report:

- Actual results 2016-17 to 2020-21: Audited Financial Statements
- Projected results 2021-22 to 2030-31: Adopted Financial Plans.

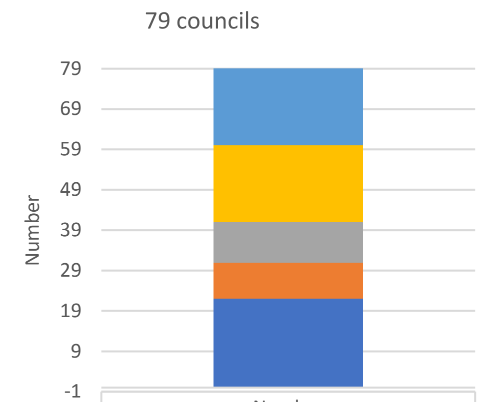
The data was sourced with the support from:

- Local Government Finance Professionals (FinPro)
- Local Government Victoria (LGV)
- Victorian Auditor-General's Office (VAGO).

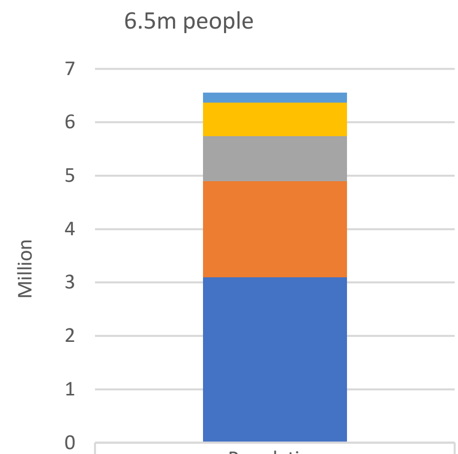
2. Fast Facts

This section provides and overview of the Victorian local government sector based on the 2020-21 year.

2.1 Sector statistics



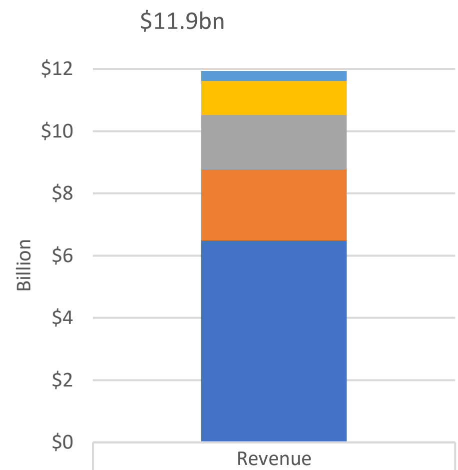
	Number
Small rural	19
Large rural	19
Regional cities	10
Interface	9
Metropolitan	22



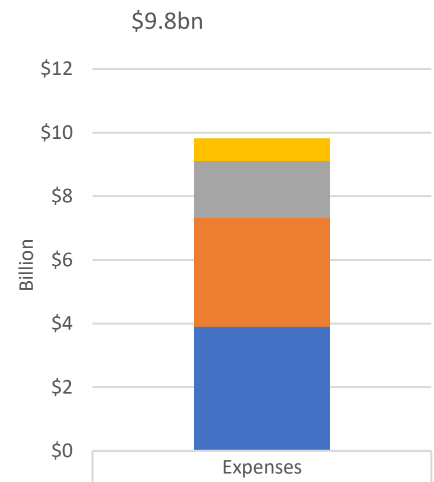
	Population
Small rural	0.19
Large rural	0.63
Regional cities	0.84
Interface	1.80
Metropolitan	3.10

2.2 Financial snapshot

Operating Performance: $2.1bn surplus



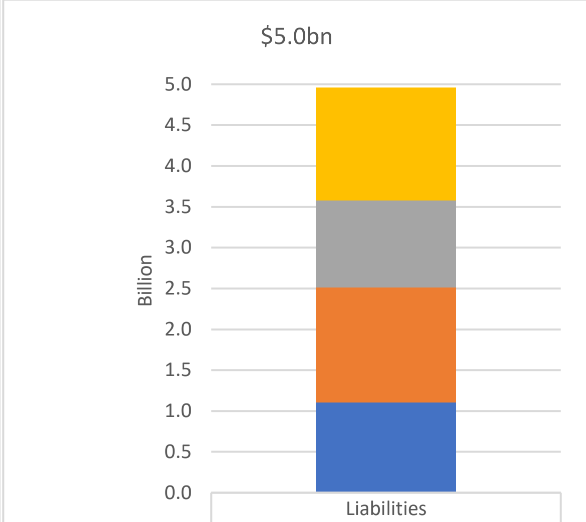
	Revenue
Other	$0.32
User fees/ fines	$1.08
Contributions	$1.76
Grants	$2.28
Rates	$6.49



	Expenses
Other	$0.69
Deprec/ amortis	$1.78
Materials & services	$3.42
Employee costs	$3.91

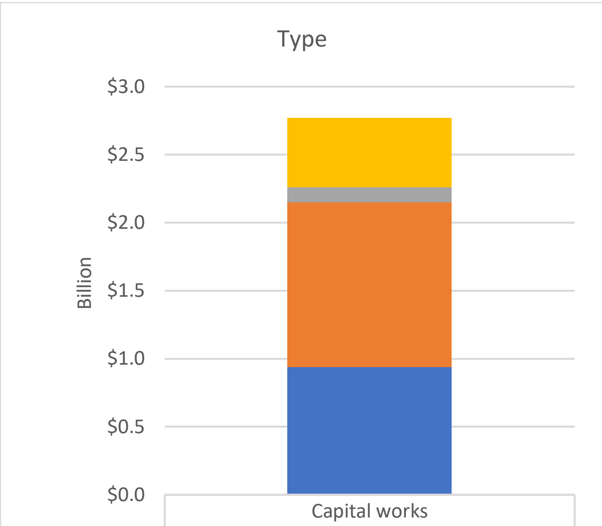
Financial Position: $188.2bn net assets

	Assets
Other	$2.26
Cash and investments	$6.79
Property, infras, plant & equip	$114.07

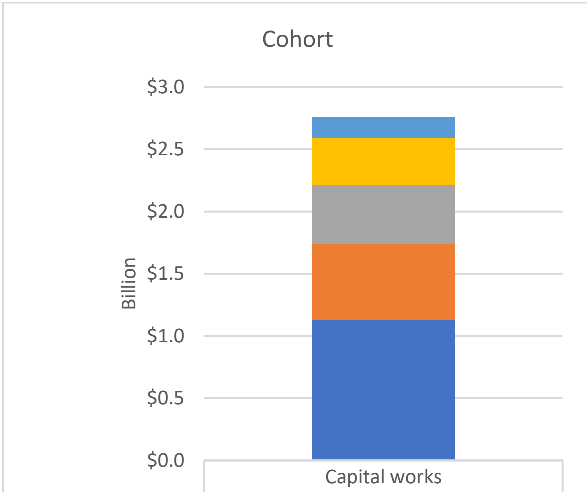


	Liabilities
Other	$1.38
Borrowings	$1.07
Provisions	$1.40
Trade payables	$1.11

Capital Works: $2.8bn

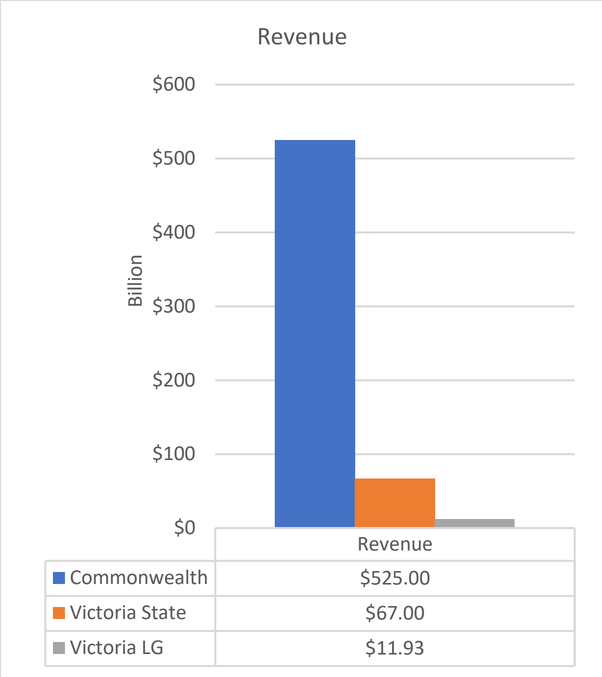


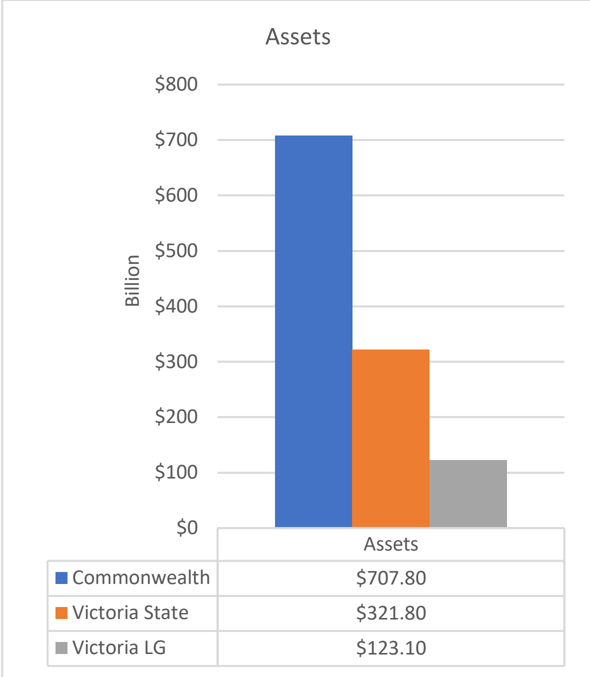
	Capital works
Upgrade	$0.51
Expansion	$0.11
Renewal	$1.21
New	$0.94



	Capital works
Small rural	$0.17
Large rural	$0.38
Regional cities	$0.47
Interface	$0.61
Metro	$1.13

2.4 Comparison against other sectors

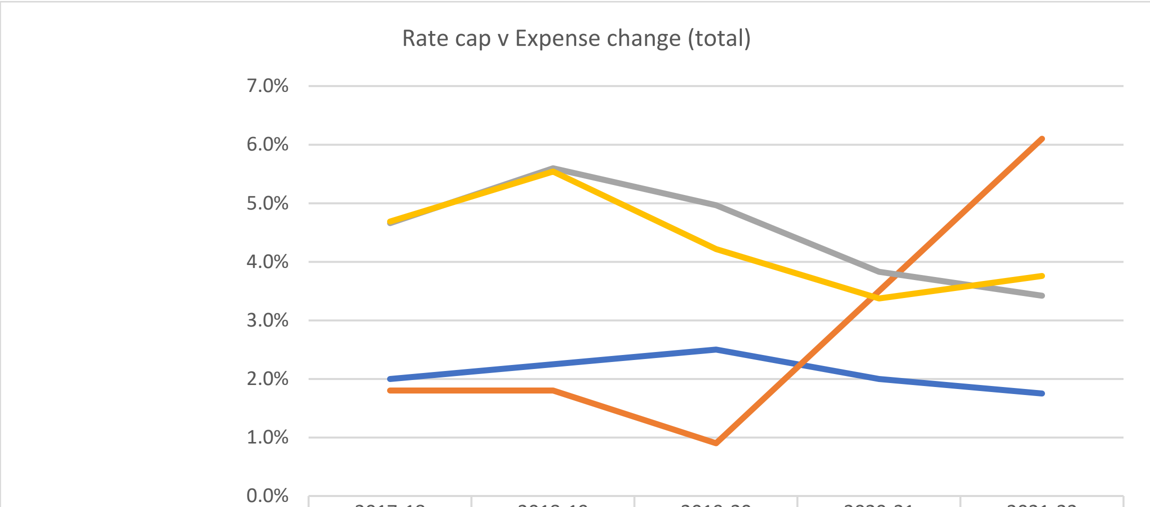




3. Financial analysis

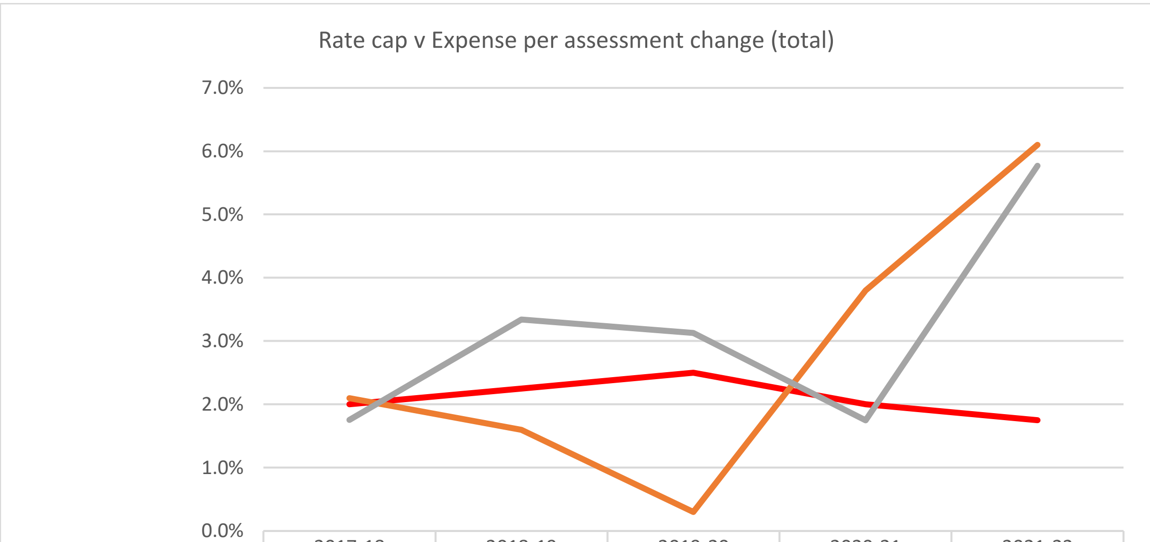
This section provides an analysis of the actual financial results of Victorian local governments based on the audited financial statements from 2016-17 to 2020-21. The analysis considers: the local government cost base; operating performance; financial position; and capital works.

3.1 Local government cost base



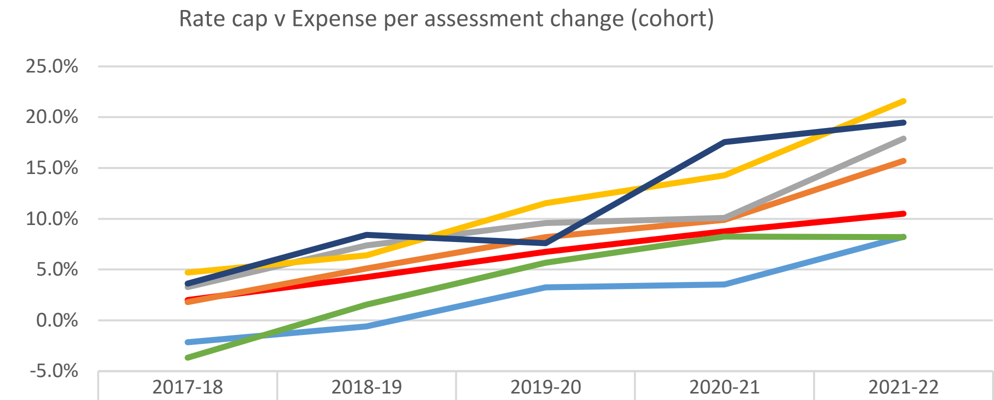
	2017-18	2018-19	2019-20	2020-21	2021-22
Rate cap	2.00%	2.25%	2.50%	2.00%	1.75%
CPI	1.8%	1.8%	0.9%	3.5%	6.1%
Expenses	4.7%	5.6%	5.0%	3.8%	3.4%
Expenses (ex dep/am)	4.7%	5.5%	4.2%	3.4%	3.8%

The above graph compares the rate cap set each year compared to the change in the local government cost base since the introduction of rate capping. In all years the annual increase in total expenditure and total expenditure excluding depreciation and amortisation has exceeded the cap.



	2017-18	2018-19	2019-20	2020-21	2021-22
Rate cap	2.00%	2.25%	2.50%	2.00%	1.75%
CPI	2.1%	1.6%	0.3%	3.8%	6.1%
Expenses per ass	1.8%	3.3%	3.1%	1.7%	5.8%

The above graph compares the rate cap set each year compared to the change in the local government cost base using expenses per assessment. This measure removes the impact of property growth especially for those councils at the Melbourne interface. Except for the 2020-21 year which was impacted by COVID-19, the annual increase in expenses per assessment has exceeded the cap.

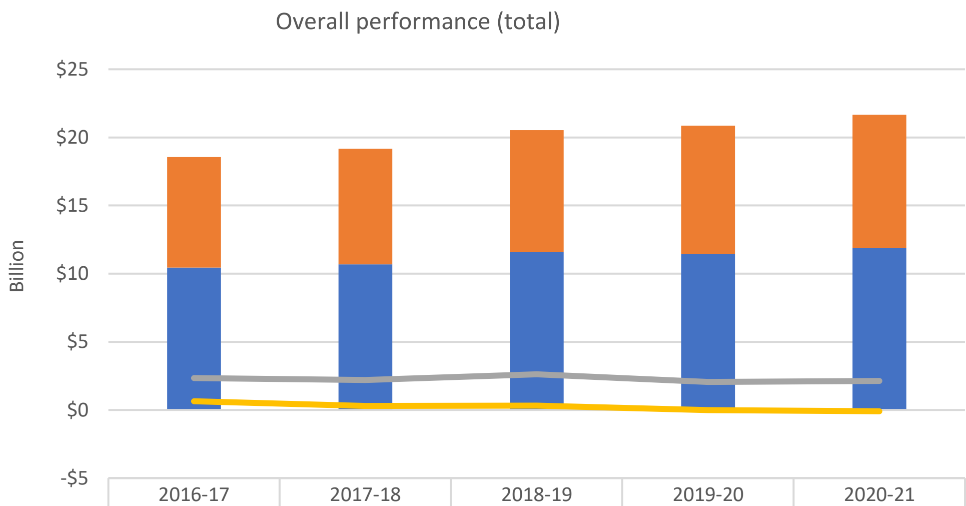


	2017-18	2018-19	2019-20	2020-21	2021-22
Rate cap	2.0%	4.3%	6.8%	8.8%	10.5%
Total	1.8%	5.1%	8.2%	9.9%	15.7%
Metro	3.3%	7.4%	9.6%	10.1%	17.9%
Interface	4.7%	6.4%	11.5%	14.3%	21.6%
Regional city	-2.2%	-0.6%	3.2%	3.5%	8.2%
Large rural	-3.7%	1.6%	5.7%	8.2%	8.2%
Small rural	3.6%	8.4%	7.6%	17.6%	19.5%

The above graph compares the rate cap set each year compared to the change in the local government cost base using total expenses per assessment for each local government cohort. The data has been expressed on a cumulative basis to show the gap between the rate cap and annual cost increases over time. Except for regional cities and large rural councils, the gap between the rate cap and annual cost increases has widened over time. This is especially significant for interface and small rural councils.

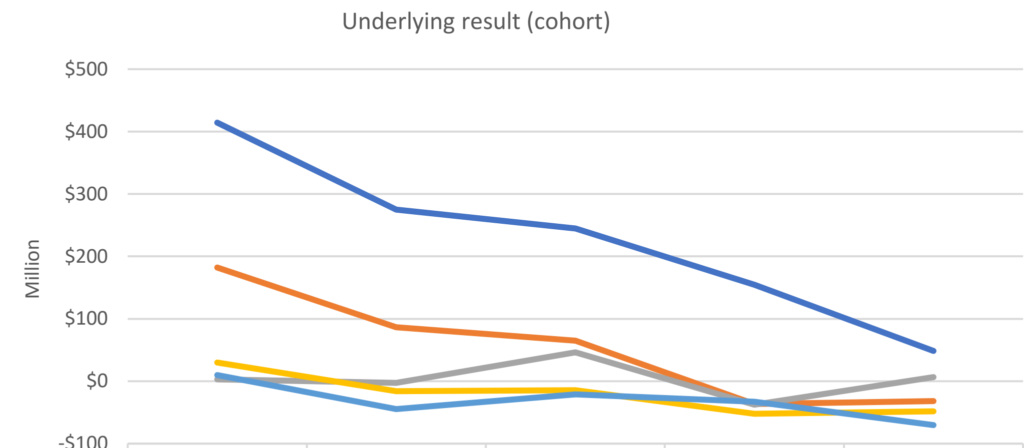
3.2 Operating performance

Overall Performance



	2016-17	2017-18	2018-19	2019-20	2020-21
Expenses	$8.11	$8.49	$8.96	$9.40	$9.76
Revenue	$10.45	$10.67	$11.58	$11.46	$11.89
Net result	$2.34	$2.19	$2.62	$2.06	$2.13
Underlying result	$0.64	$0.30	$0.32	$0.00	-$0.09

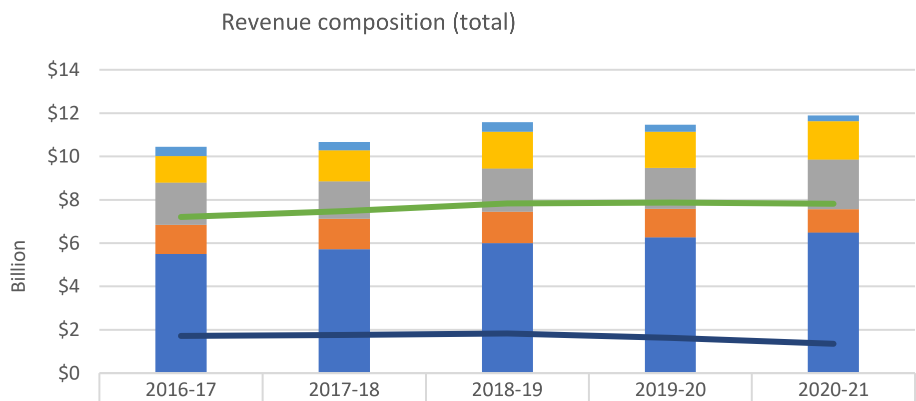
The above graph compares revenues and expenses over time along with the net result and underlying result. Underlying result removes the financial impact of capital grants and contributions which are not matched by operating expenditure. Since 2016-17 the underlying result has been eroded over time as the annual increase in expenses has outstripped the increase in operating revenues. The 2019-20 and 2020-21 years show that the sector as a whole experienced underlying deficits which was magnified by the impacts of COVID-19.



	2016-17	2017-18	2018-19	2019-20	2020-21
Metro	$414	$275	$245	$154	$49
Interface	$182	$86	$65	-$37	-$32
Regional city	$3	-$2	$46	-$38	$7
Large rural	$30	-$16	-$14	-$52	-$48
Small rural	$10	-$44	-$21	-$33	-$70

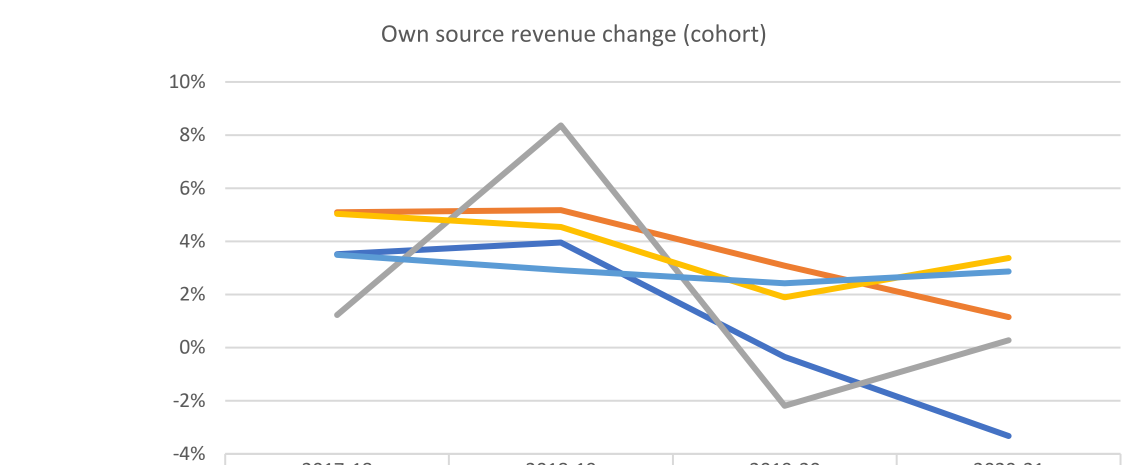
The above graph compares the underlying result by local government cohort. Except for metro councils, all cohorts experienced underlying deficits in 2019-20 with only regional cities recovering to achieve a surplus in 2020-21. Small and large rural councils have achieved underlying deficits since 2017-18 with small rural councils experiencing a significant downward trend.

Revenue



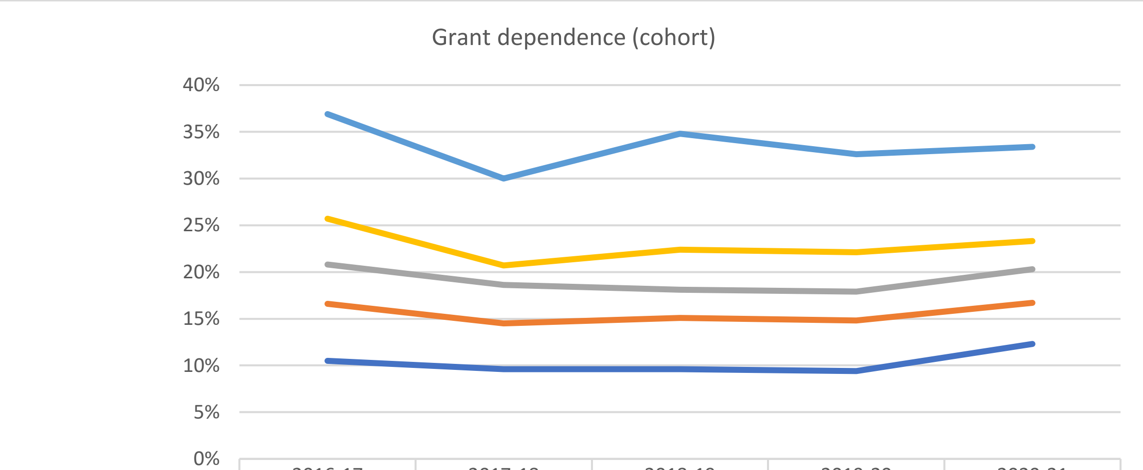
	2016-17	2017-18	2018-19	2019-20	2020-21
Other revenue	$0.44	$0.39	$0.43	$0.33	$0.27
Contributions	$1.22	$1.43	$1.70	$1.67	$1.76
Grants	$1.95	$1.73	$2.00	$1.89	$2.28
Fees/ fines	$1.35	$1.41	$1.44	$1.30	$1.08
Rates	$5.49	$5.71	$6.01	$6.27	$6.49
Own source	$7.21	$7.47	$7.84	$7.87	$7.81
Own source (ex rates)	$1.71	$1.76	$1.83	$1.63	$1.35

The above graph compares the different revenue sources of councils over time along with own source revenue and own source revenue excluding rates. Own source revenue excludes government grants and contributions. Since the introduction of rate capping own source revenue has remained steady over time. However, when rates are removed, other sources of revenue such as user fees and fines have steadily declined especially in 2019-20 and 2020-21 during COVID-19.



	2017-18	2018-19	2019-20	2020-21
Metro	3.5%	4.0%	-0.4%	-3.3%
Interface	5.1%	5.2%	3.1%	1.1%
Regional city	1.2%	8.4%	-2.2%	0.3%
Large rural	5.0%	4.5%	1.9%	3.4%
Small rural	3.5%	2.9%	2.4%	2.9%

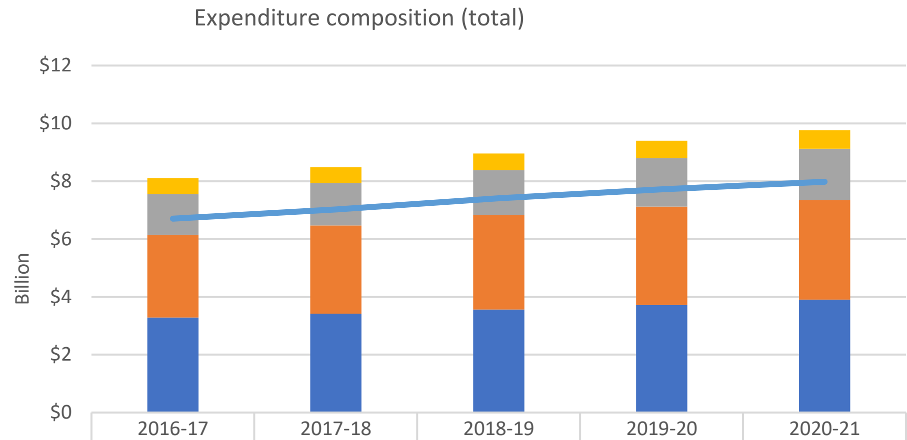
The above graph compares own source revenue by local government cohort and shows the impact COVID-19 on larger councils who generate significant income from other sources such as parking fees and fines. Rural councils have been less affected due to the relatively low levels of own source revenue generated however there is still a downward trend over time.



	2016-17	2017-18	2018-19	2019-20	2020-21
Metro	10.5%	9.6%	9.6%	9.4%	12.3%
Interface	16.6%	14.5%	15.1%	14.8%	16.7%
Regional cities	20.8%	18.6%	18.1%	17.9%	20.3%
Large rural	25.7%	20.7%	22.4%	22.1%	23.3%
small rural	36.9%	30.0%	34.8%	32.6%	33.4%

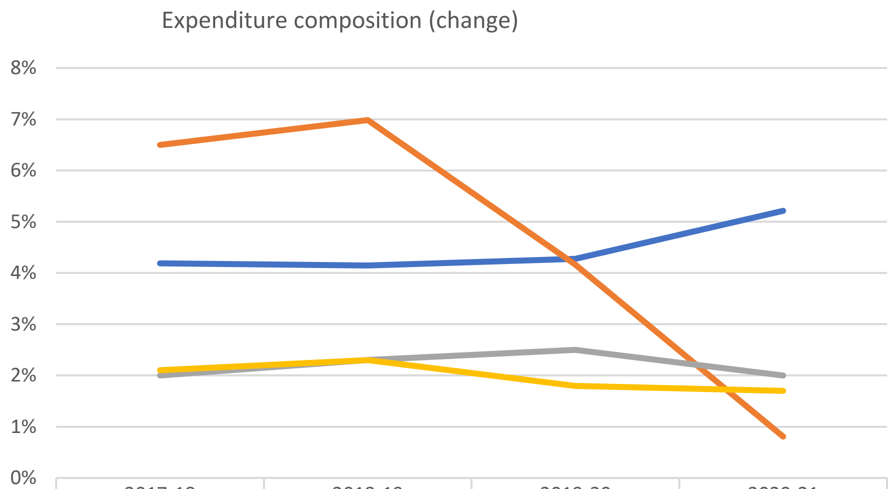
The above graph compares total operating grants as a percentage of total revenue (excluding capital grants and contributions) over time. Small rural councils have the largest dependence of operating grants accounting for a third of their operating revenue.

Expenditure



	2016-17	2017-18	2018-19	2019-20	2020-21
Other expenses	$0.55	$0.54	$0.58	$0.60	$0.64
Depreciation/ amortisation	$1.40	$1.47	$1.55	$1.68	$1.78
Materials/ services	$2.87	$3.05	$3.27	$3.40	$3.43
Employee costs	$3.28	$3.42	$3.56	$3.72	$3.91
Expenses (ex dep/am)	$6.71	$7.02	$7.41	$7.72	$7.98

The above graph compares the different expenditure sources of councils over time along with total expenses excluding depreciation and amortisation. The graph shows that all expenditure sources have increased significantly over time since the introduction of rate capping.

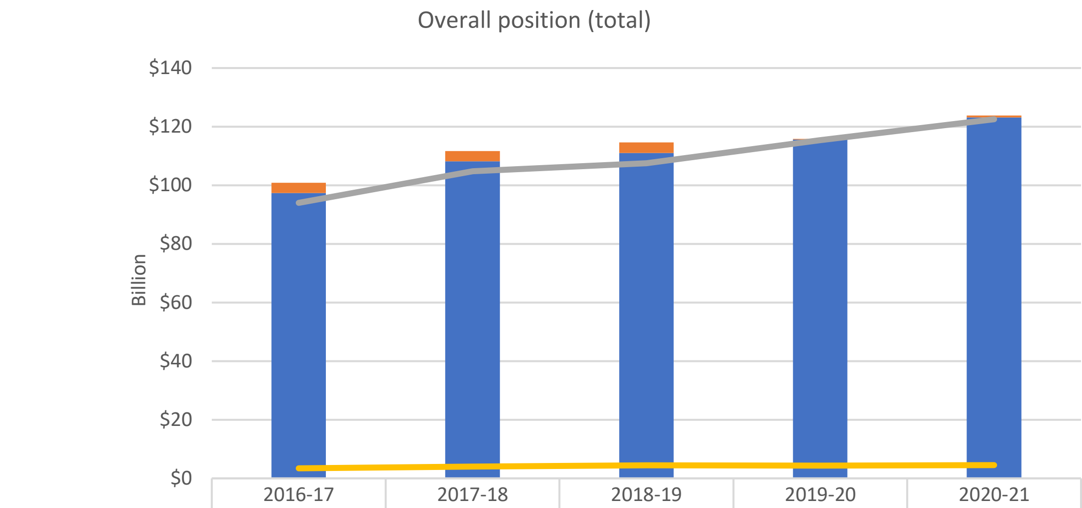


	2017-18	2018-19	2019-20	2020-21
Employee costs	4.2%	4.1%	4.3%	5.2%
Materials & services	6.5%	7.0%	4.2%	0.8%
Rate cap	2.0%	2.3%	2.5%	2.0%
Wages index	2.1%	2.3%	1.8%	1.7%

The above graph compares the change in employee costs and materials & services to the rate cap and wage price index. In all years since 2016-17, the annual increase in employee costs has exceeded the rate cap and wage price index. The 2019-20 and 2020-21 years show the impact of COVID-19 on labour shortages and pressure placed on wages compared to the impact on materials & services which reflect the shutting down of customer facing services.

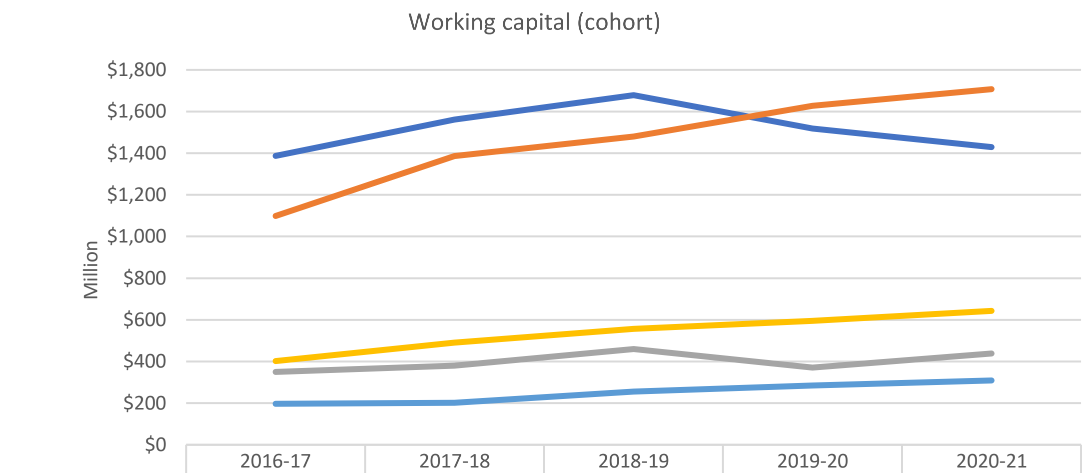
3.3 Financial Position

Overall Position



	2016-17	2017-18	2018-19	2019-20	2020-21
Total liabilities	$3.40	$3.44	$3.59	$0.19	$0.61
Total assets	$97.40	$108.22	$111.07	$115.60	$123.14
Net assets	$94.01	$104.78	$107.48	$115.41	$122.53
Working capital	$3.43	$4.02	$4.43	$4.40	$4.53

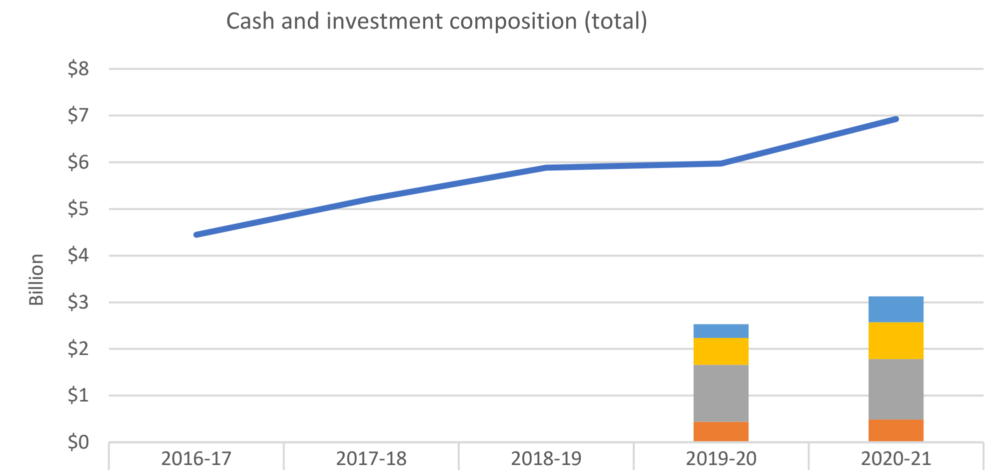
The above graph compares total assets and liabilities over time along with net assets and working capital (current assets less current liabilities). Since 2016-17, net assets and working capital have increased with a slight reduction in 2019-20 as a result of COVID-19.



	2016-17	2017-18	2018-19	2019-20	2020-21
Metro	$1,387	$1,562	$1,679	$1,519	$1,429
Interface	$1,099	$1,387	$1,480	$1,628	$1,707
Regional city	$350	$380	$460	$371	$438
Large rural	$402	$490	$557	$595	$643
Small rural	$197	$201	$255	$285	$309

The above graph compares working capital by local government cohort. Except for metro councils and regional cities, all cohorts experienced increasing levels of working capital over the five year period. Metro and regional cities experienced decreases in working capital in 2019-20 as a result of COVID-19.

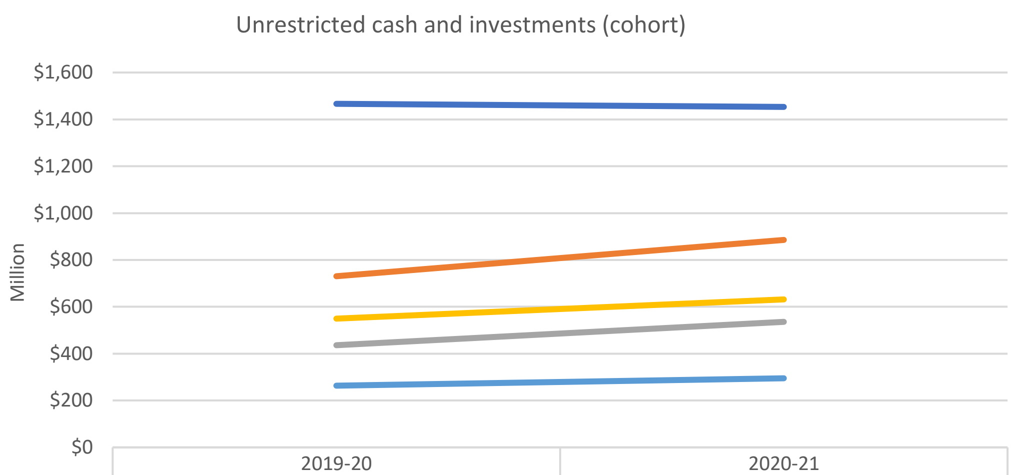
Cash and Investments



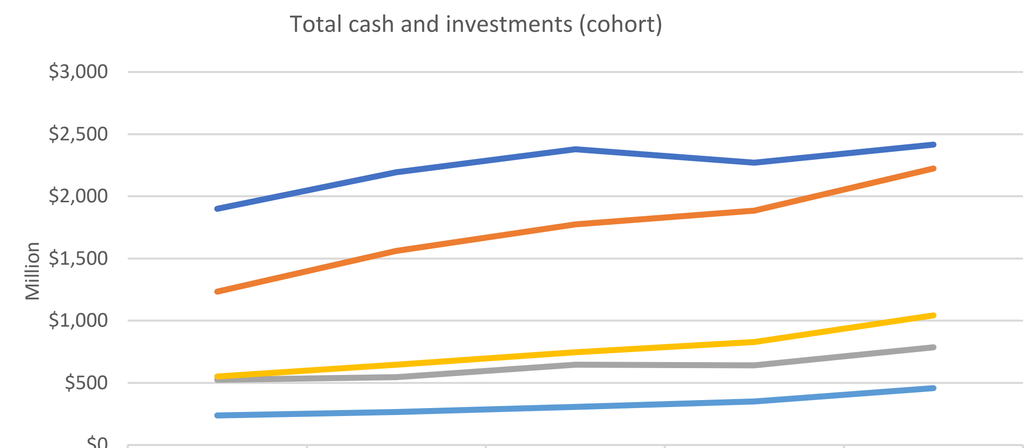
	2016-17	2017-18	2018-19	2019-20	2020-21
Unspect grants	$0.00	$0.00	$0.00	$0.29	$0.56
Cfwd capital	$0.00	$0.00	$0.00	$0.57	$0.79
Stat reserves	$0.00	$0.00	$0.00	$1.22	$1.29
Trust funds	$0.00	$0.00	$0.00	$0.44	$0.49
Total	$4.45	$5.21	$5.88	$5.98	$6.93

NB: Restricted cash breakup not available prior to 2019-20. Total includes current and non-current cash and investments

The above graph shows total cash and investments over time and the make-up of restricted cash in the 2019-20 and 2020-21 years. Restricted cash is not available for general use as it either must be spent on in a particular manner or must be repaid once certain obligations have been met. Since 2016-17, total cash and investments has increased from $4.45 billion to $6.93 billion with restricted cash accounting for 42% and 45% of the total for the 2019-20 and 2020-21 years respectively. Of the restricted cash, developer contributions held in reserves and cash held to fund incomplete capital works projects make up the majority. The graph below shows the level of unrestricted cash and investments by cohort for the 2019-20 and 2020-21 years.



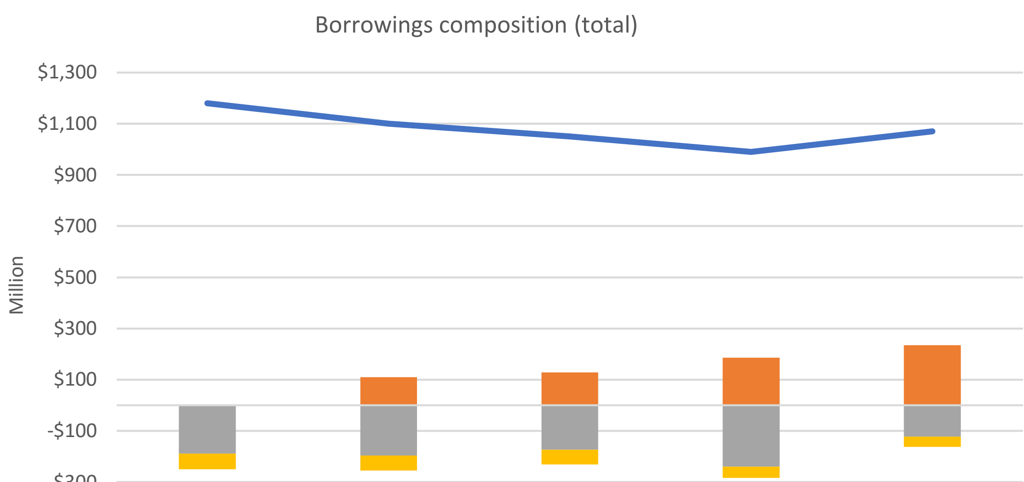
	2019-20	2020-21
Metro	$1,466	$1,453
Interface	$730	$885
Regional city	$436	$536
Large rural	$550	$632
Small rural	$263	$295



	2016-17	2017-18	2018-19	2019-20	2020-21
Metro	$1,900	$2,195	$2,380	$2,272	$2,416
Interface	$1,234	$1,562	$1,775	$1,885	$2,224
Regional city	$524	$546	$645	$641	$786
Large rural	$551	$647	$747	$828	$1,043
Small rural	$238	$264	$306	$349	$457

The above graph compares total cash and investments by local government cohort. Except for metro councils and regional cities, all cohorts experienced increasing levels of cash and investments over the five year period. Metro and regional cities experienced decreases in working capital in 2019-20 as a result of COVID-19.

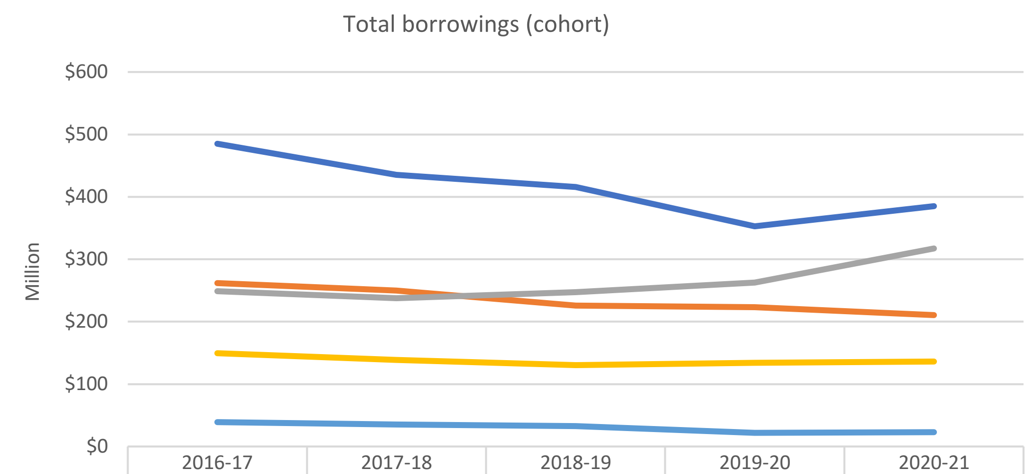
Borrowings



	2016-17	2017-18	2018-19	2019-20	2020-21
Interest	-$61	-$58	-$57	-$43	-$40
Repayment	-$189	-$196	-$174	-$240	-$123
Proceeds		$109	$128	$185	$235
Total	$1,180	$1,100	$1,050	$990	$1,070

NB: Proceeds from borrowings not available prior to 2017-18.

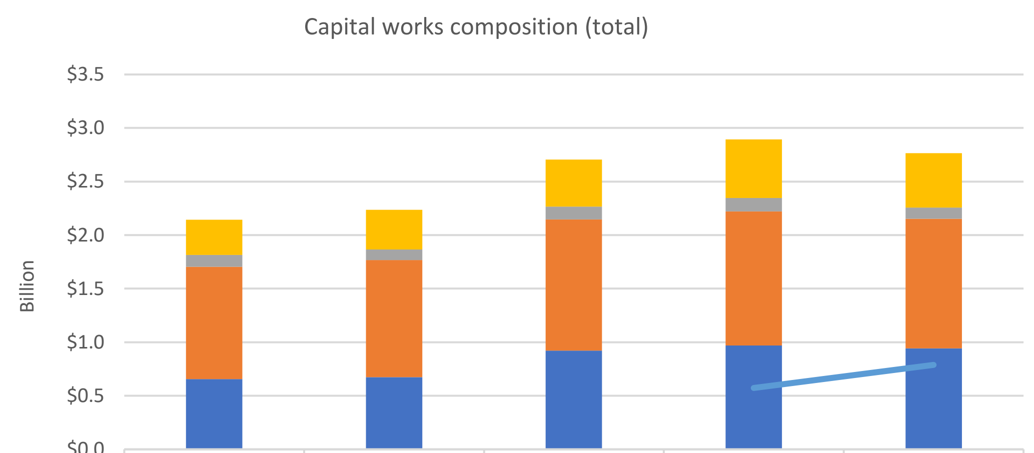
The above graph shows total borrowings over time and the make-up of annual changes from proceeds and repayments as well as interest. Since 2016-17, total borrowings has decreased from $1.18 billion to $0.99 billion in 2019-20 and then increased to $1.07 billion in 2020-21. Except for the 2020-21 year borrowing repayments has exceed proceeds from new borrowings with a repayment high of $240 million in 2019-20.



	2016-17	2017-18	2018-19	2019-20	2020-21
Metro	$485	$435	$416	$353	$385
Interface	$262	$250	$226	$223	$211
Regional city	$249	$238	$247	$263	$317
Large rural	$149	$139	$130	$134	$136
Small rural	$39	$35	$33	$22	$23

The above graph compares total borrowings by local government cohort. Except for regional cities, all cohorts experienced decreasing levels of borrowings over the five year period. Metro and regional cities experienced increases in borrowing levels in 2020-21 as a result of COVID-19 economic stimulus.

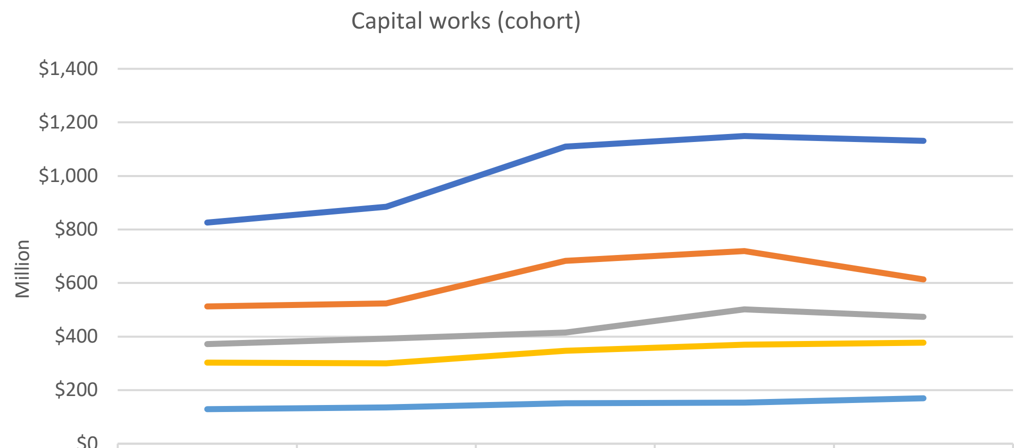
3.4 Capital works



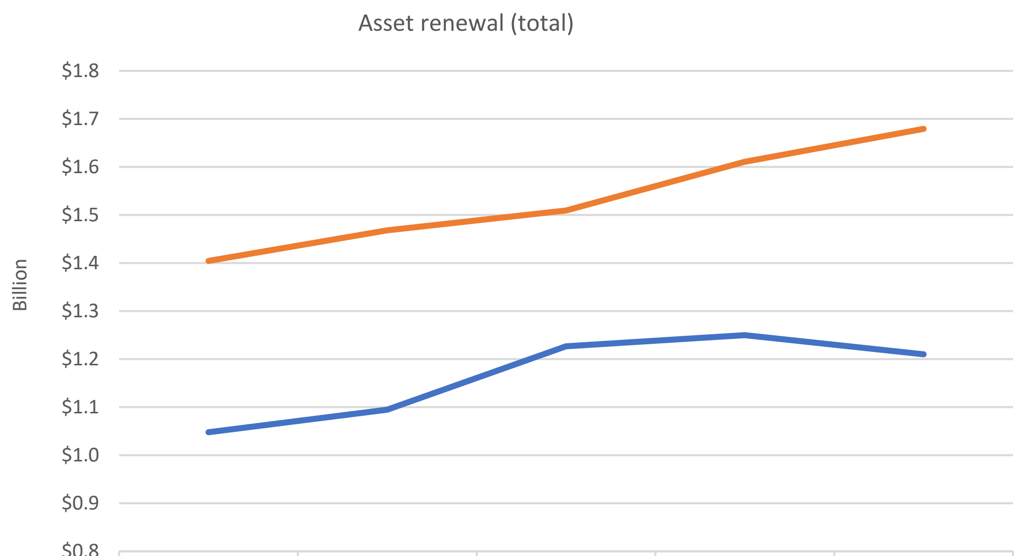
	2016-17	2017-18	2018-19	2019-20	2020-21
Upgrade	$0.33	$0.37	$0.44	$0.55	$0.51
Expansion	$0.11	$0.10	$0.12	$0.13	$0.11
Renewal	$1.05	$1.09	$1.23	$1.25	$1.21
New	$0.66	$0.67	$0.92	$0.97	$0.94
Cfwd capital				$0.57	$0.79

NB: Carry forward capital not available prior to 2019-20.

The above graph shows total capital works over time and the make-up of the type of capital expenditure including upgrade, expansion, renewal and new. The amount of capital works incomplete (carry forward capital) at the end of the 2019-20 and 2020-21 years has also been included. Since 2016-17, total capital works has increased from $2.15 billion to $2.90 billion in 2019-20 and then decreased to $2.77 billion in 2020-21. Carry forward capital works increased significantly from $0.57 billion (16%) in 2019-20 to $0.79 billion (22%) in 2020-21 reflecting the impact of COVID-19 economic stimulus. The graph below shows the level of capital works by cohort for the same five year period.

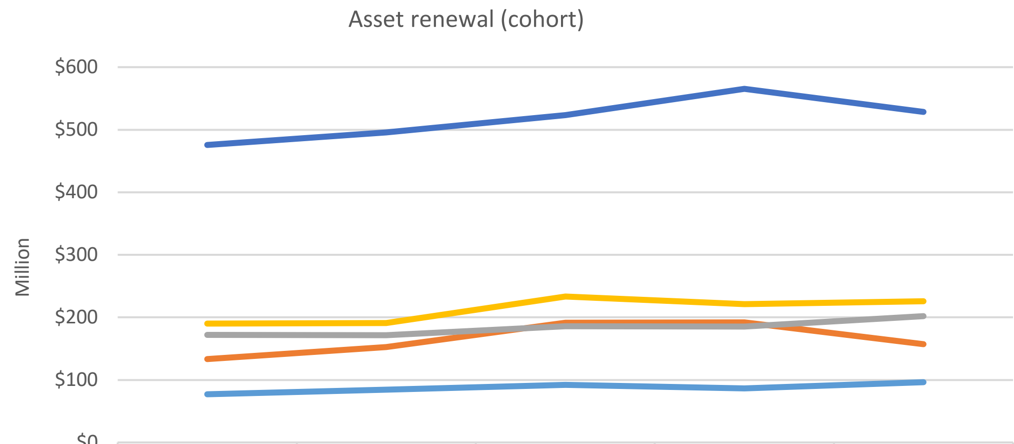


	2016-17	2017-18	2018-19	2019-20	2020-21
Metro	$826	$885	$1,109	$1,149	$1,131
Interface	$513	$523	$683	$719	$613
Regional city	$372	$393	$415	$502	$473
Large rural	$303	$300	$348	$370	$377
Small rural	$129	$135	$151	$153	$170



	2016-17	2017-18	2018-19	2019-20	2020-21
Renewal	$1.05	$1.09	$1.23	$1.25	$1.21
Depreciation	$1.40	$1.47	$1.51	$1.61	$1.68

The above graph shows total asset renewal over time compared to annual depreciation. Depreciation is considered a proxy for the amount of funds that councils should be investing in renewing existing assets each year. Since 2016-17, total asset renewal has totalled $5.83 billion compared to total depreciation of $7.67 billion resulting in an asset renewal gap of $1.84 billion over the five year period. The graph also shows that the level of asset renewal plateaued and then decreased in 2019-20 and 2020-21 as a result of COVID-19. The graph below shows the level of asset renewal by cohort for the same five year period.



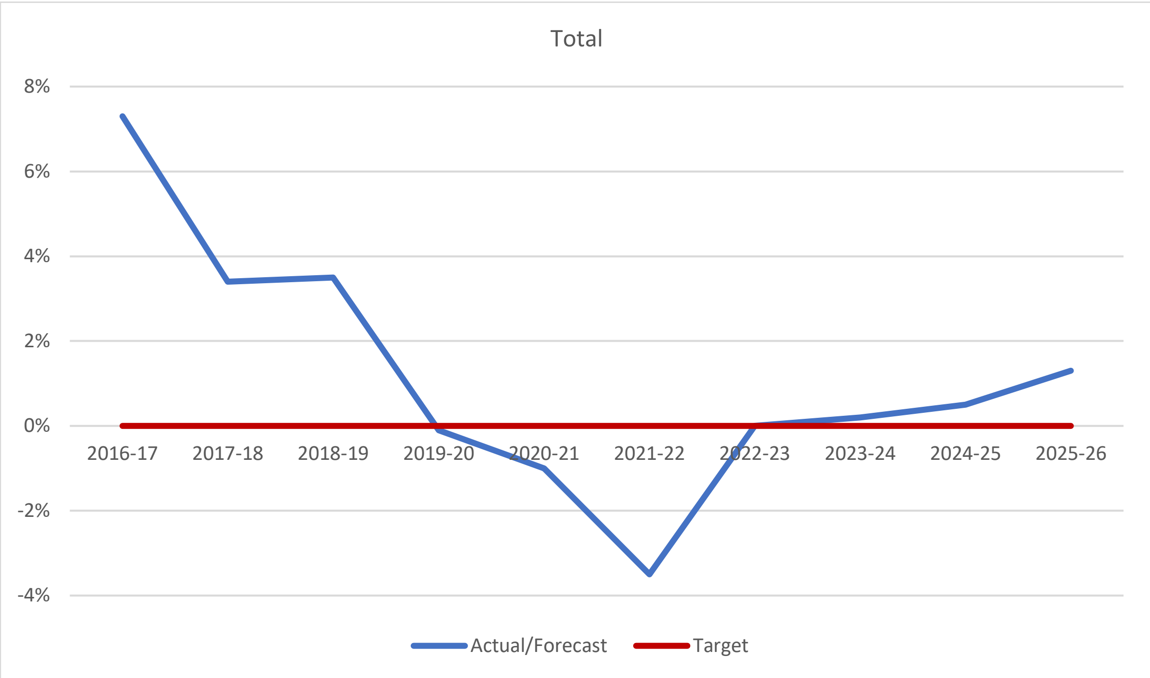
	2016-17	2017-18	2018-19	2019-20	2020-21
Metro	$476	$496	$523	$565	$528
Interface	$133	$153	$192	$192	$157
Regional city	$172	$171	$186	$185	$202
Large rural	$190	$191	$233	$221	$226
Small rural	$77	$84	$92	$86	$96

4. Financial viability

This section considers the financial viability of the sector based on a 10 year analysis of the 2016-17 to 2020-21 actual financial results and forecast results for the years 2021-22 to 2025-26. The analysis is based on the Local Government Performance Reporting Framework (LGPRF) key indicators: adjusted underlying result; working capital; unrestricted cash; debt level; and asset renewal.

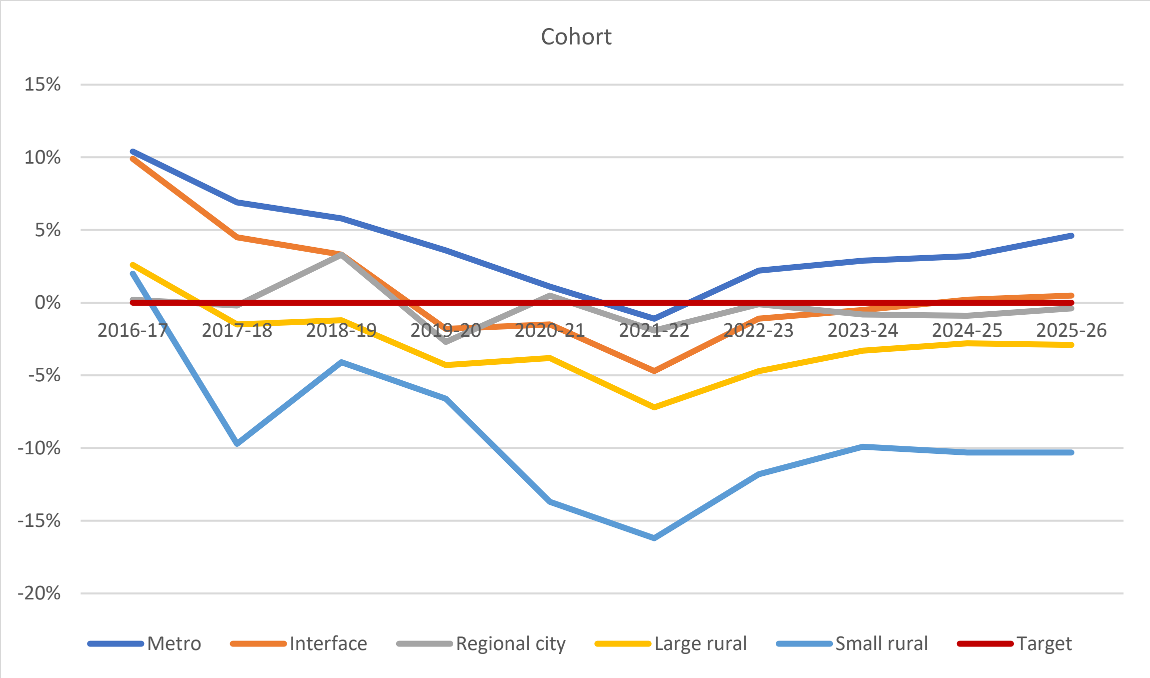
4.1 Adjusted underlying result

The adjusted underlying result is the first of the LGPRF operating position indicators that measures whether a council can generate sufficient adjusted revenue to meet total expenses. It is measured by comparing the adjusted underlying result to adjusted underlying revenue, expressed as a percentage. An adjusted underlying surplus indicates that a council can generate sufficient revenue to meet its expenses. The accepted target is greater than 0%.



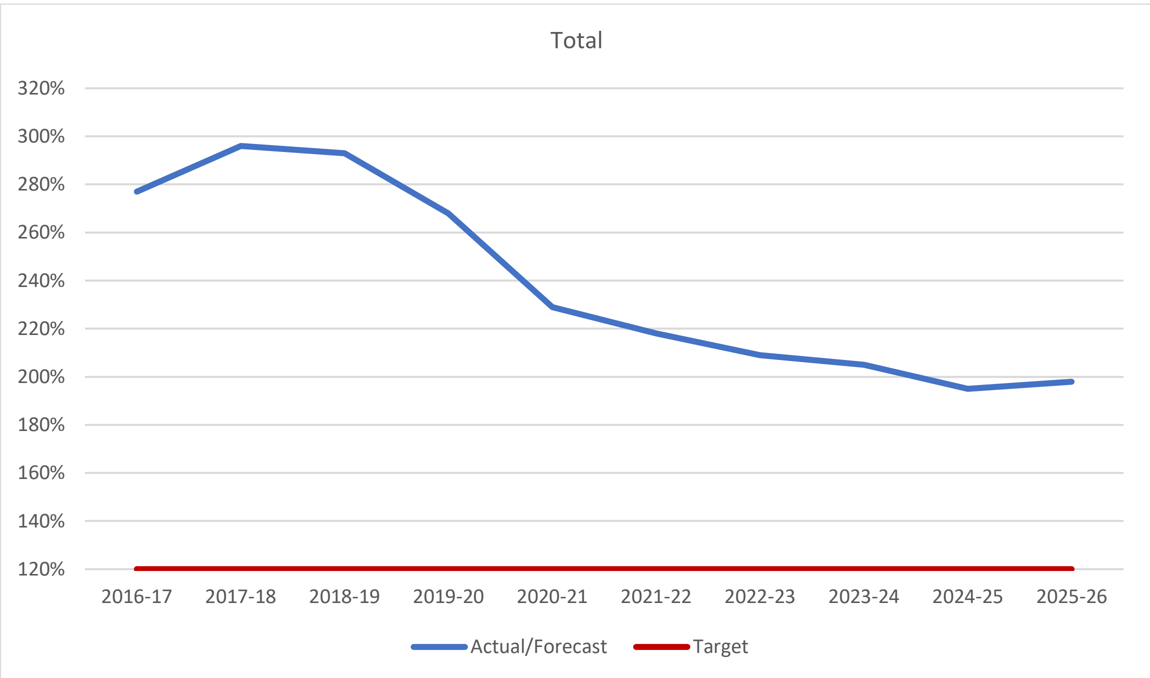
The above graph shows a significant decline in the overall adjusted underlying result from a positive 7.3% in 2016-17 to a deficit of -3.5% in 2021-22. The latter two years also being impacted of COVID-19. The result is forecast to become positive from 2022-23.

The graph below shows the adjusted underlying results over the same period by local government cohort. Except for metro and interface councils, all cohorts are forecast to have underlying deficits by 2025-26.



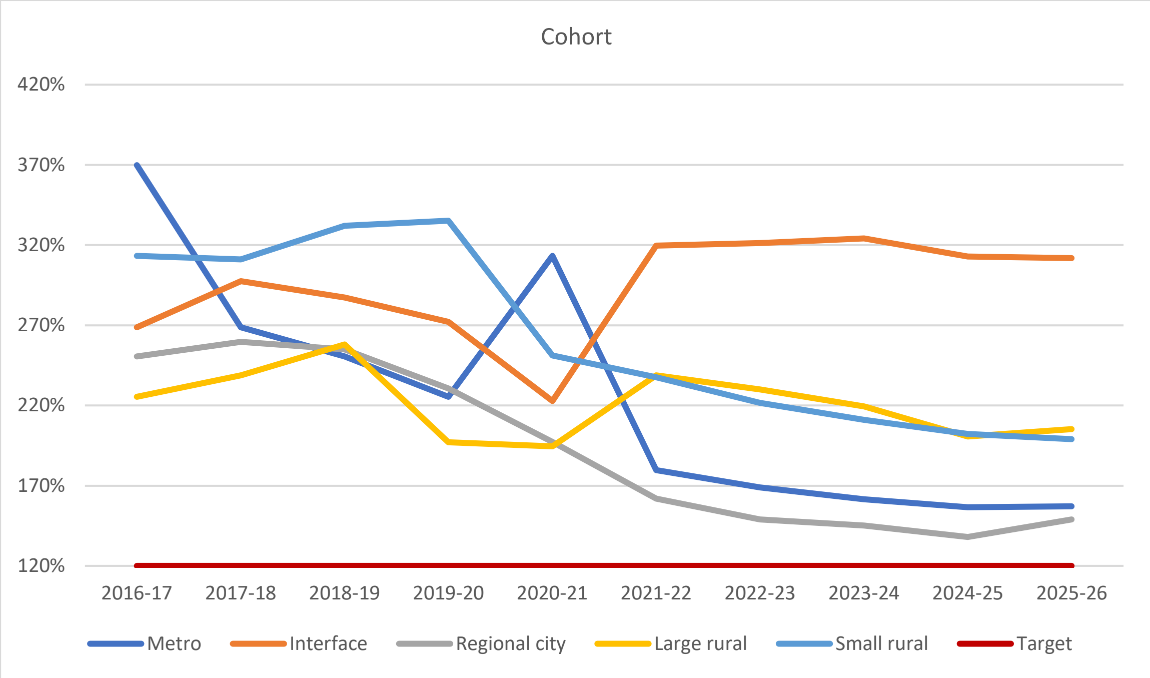
4.2 Working capital

Working capital is the first of the LGPRF liquidity indicators that measures whether a council can generate sufficient cash to pay its bills on time. It is measured by comparing current assets to current liabilities, expressed as a percentage. Higher current assets relative to current liabilities suggest that a council is in a strong financial position. The accepted target is greater than 120%.



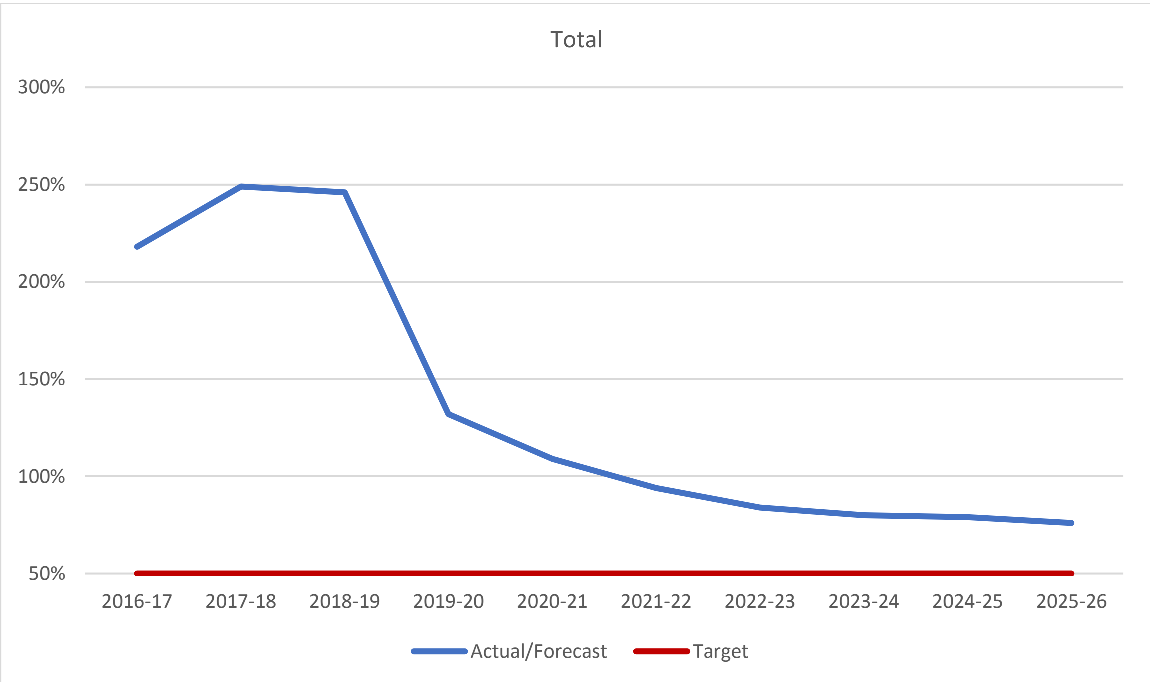
The above graph shows a significant decline in working capital from 296% in 2017-18 to a deficit to 200% in 2021-22.

The graph below shows the working capital results over the same period by local government cohort.



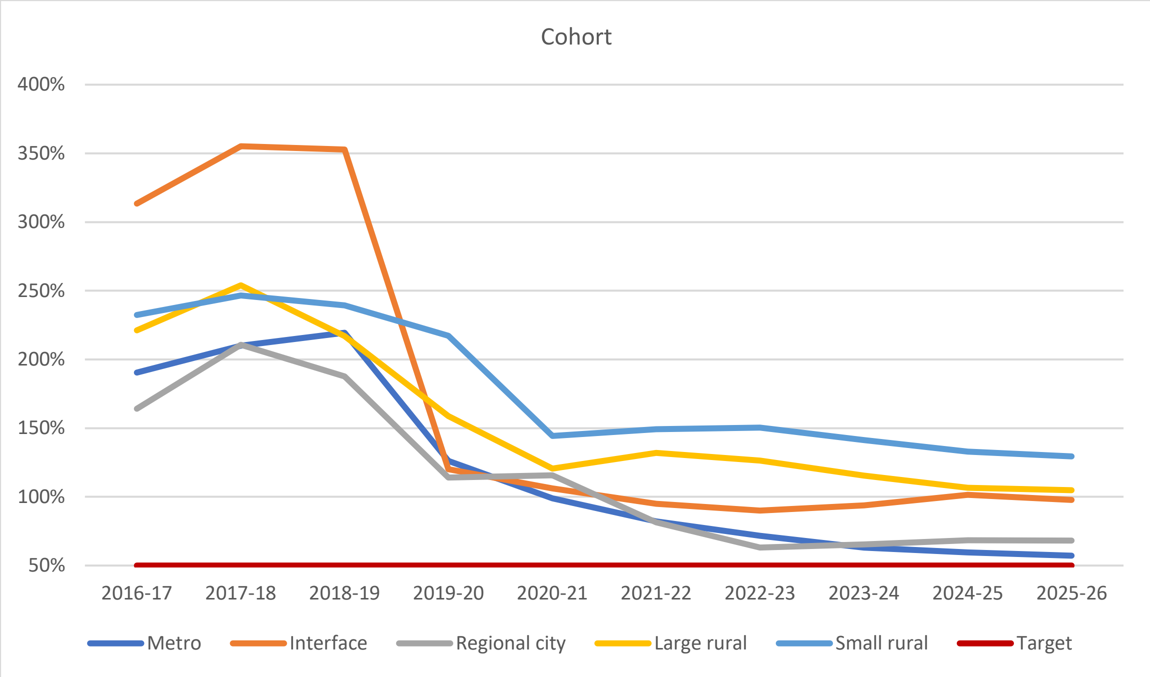
4.3 Unrestricted cash

Unrestricted cash is the second of the LGPRF liquidity indicators that measures whether a council can generate sufficient cash to pay its bills on time. It is measured by comparing unrestricted cash to current liabilities, expressed as a percentage. Unrestricted cash is cash and cash equivalents that are available for use and free of obligations. Higher unrestricted cash relative to current liabilities suggest that a council can pay its bills on time. The accepted target is greater than 50%.



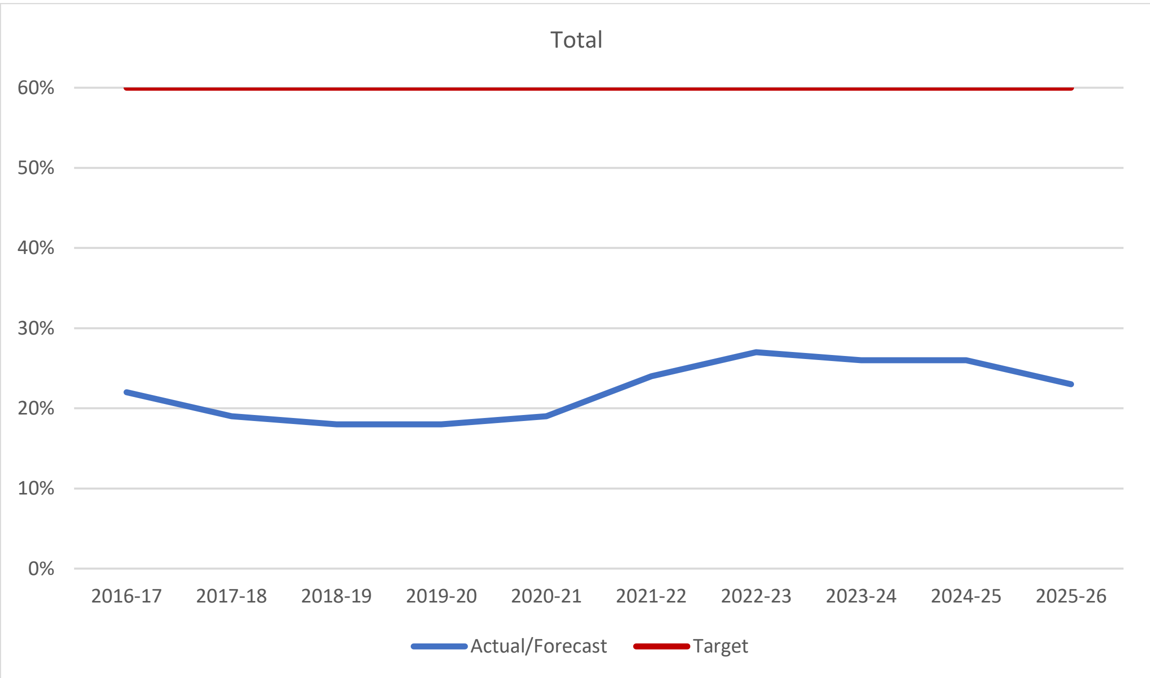
The above graph shows that unrestricted cash peaked at 249% in 2017-18 followed by a significant decline to 109% in 2020-21. The decline is forecast to continue to 76% by 2025-26.

The graph below shows the unrestricted results over the same period by local government cohort. Metro councils and regional cities are forecast to have unrestricted cash levels close to the target of 50% by 2025-26.



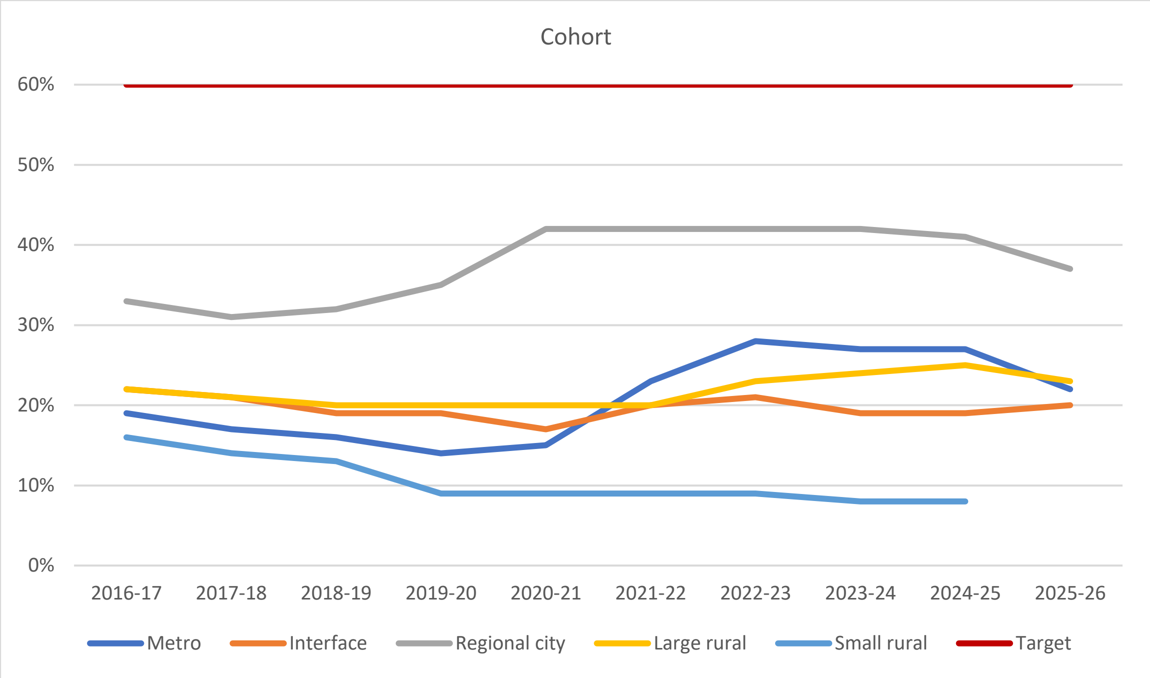
4.4 Debt level

Debt level is the first of the LGPRF obligations indicators that measures whether the level of debt and other long term obligations is appropriate to the size and nature of a council's activities. It is measured by comparing loans and borrowings to rates, expressed as a percentage. The level of debt should reflect the adopted borrowing strategy of a council. The accepted target is less than 60%.



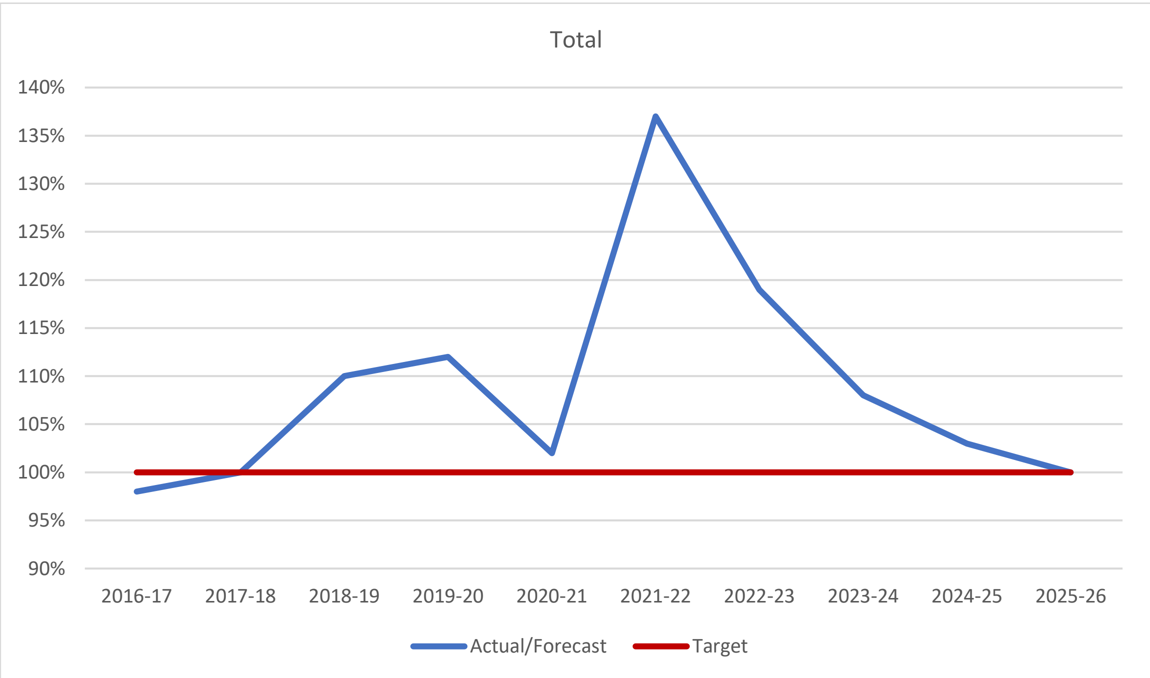
The above graph that debt levels are forecast to peak at 27% in 2022-23 followed by a decline to 23% by 2025-26.

The graph below shows the debt level results over the same period by local government cohort. Regional cities are forecast to have the highest debt levels at 42% by 2020-21 and expected to remain at that level until 2023-24 with a slight reduction by 2025-26.



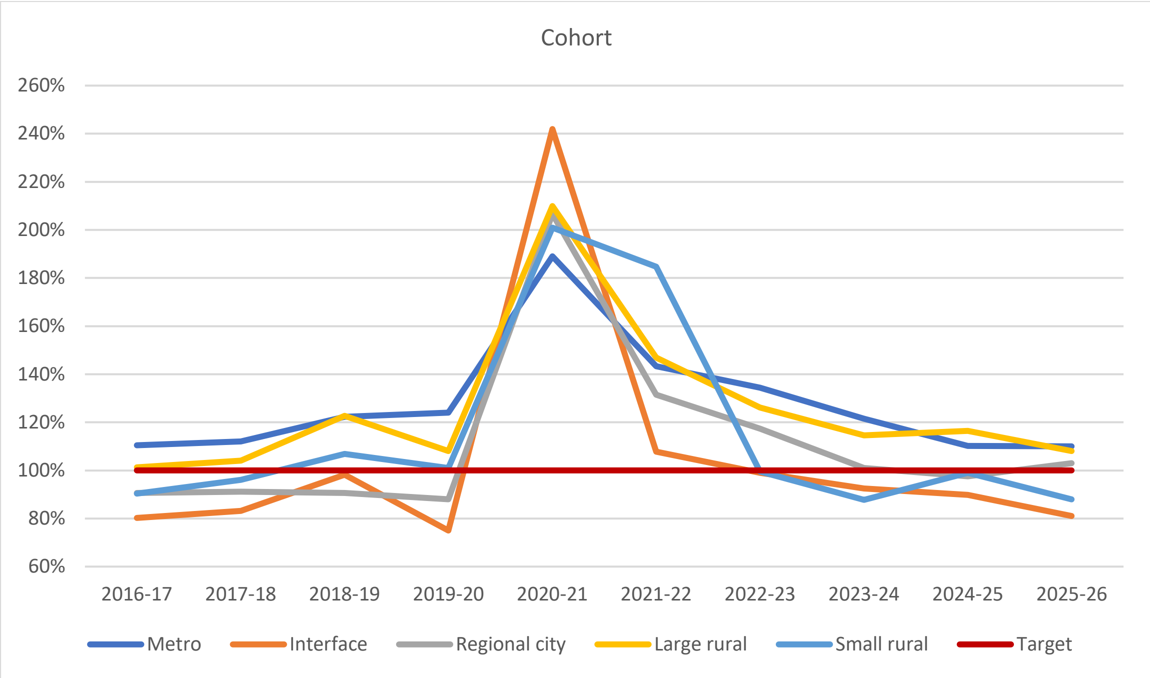
4.5 Asset renewal

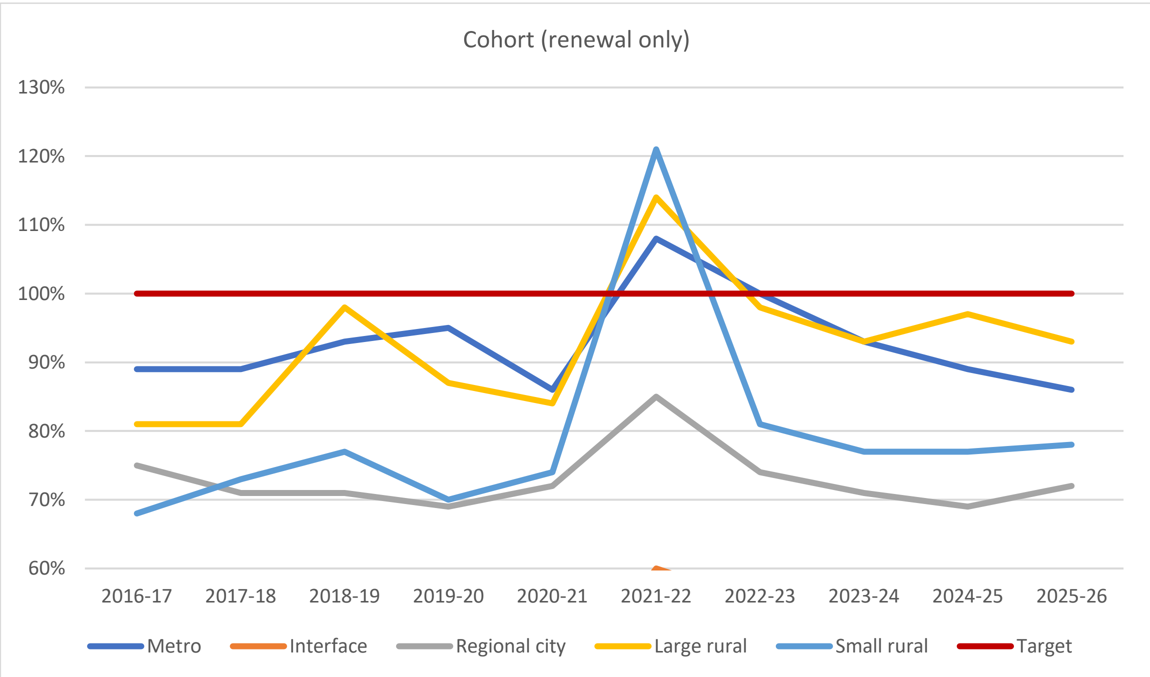
Asset renewal is the fourth of the LGPRF obligations indicators that measures whether the level of debt and other long term obligations is appropriate to the size and nature of a council's activities. It is measured by comparing asset renewal and upgrade expense to depreciation, expressed as a percentage. Higher levels of asset renewal compared to depreciation indicate that council assets are being renewed or upgraded as planned. The accepted target is 100%.



The above graph shows that asset renewal levels are forecast to peak at 137% in 2021-22 followed by a decline to 100% by 2025-26.

The graph below shows the asset renewal results over the same period by local government cohort. Interface and small rural councils are forecast to have asset renewal levels below 100% from 2022-23. Other cohorts are forecast to remain just above 100% over the outlook period.

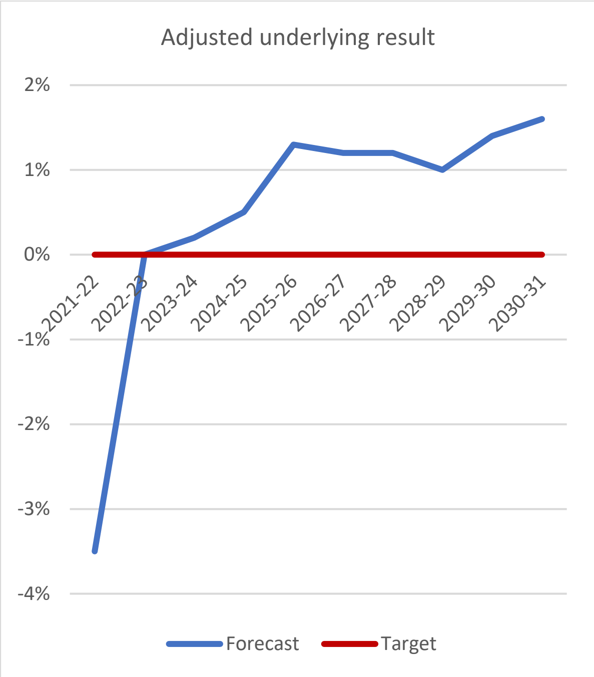


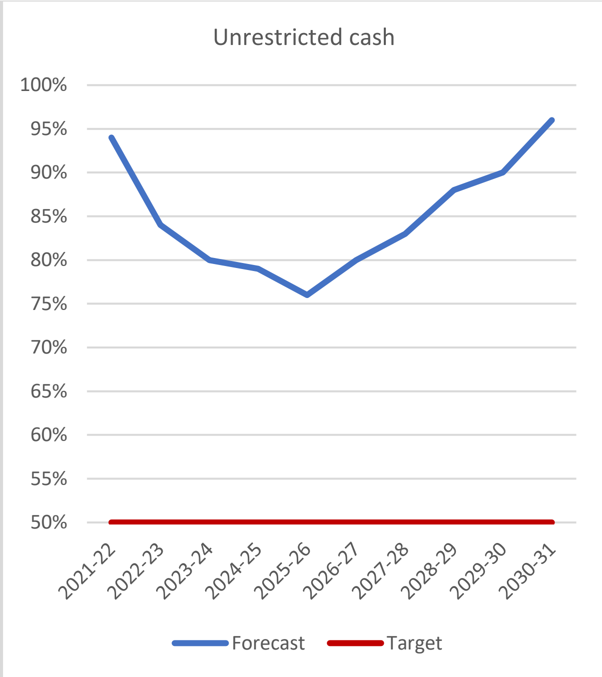


The graph above shows the asset renewal results over the same period by local government cohort excluding asset upgrade. Except for the 2021-22 year, all councils have achieved and are forecast to have asset renewal levels below 100%.

4.6 Long term viability

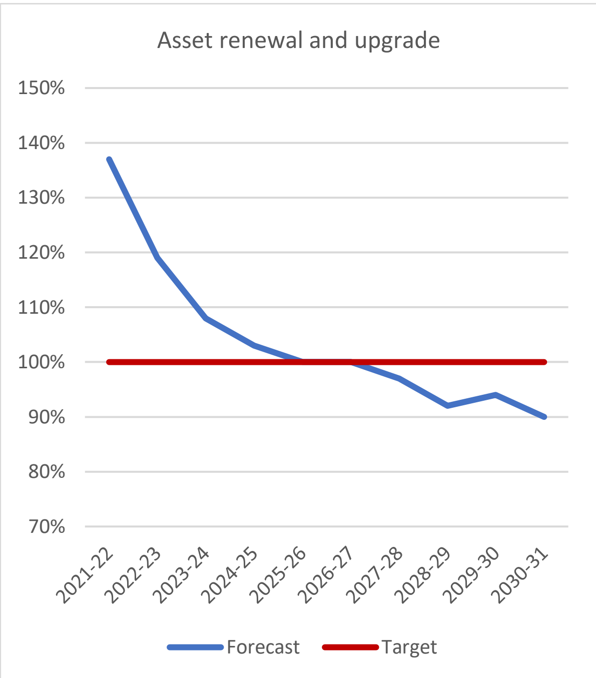
The following graphs shows the results for the LGPRF key indicators of adjusted underlying result, unrestricted cash and asset renewal (including and excluding upgrade expenditure) for the 10 years 2021-22 to 2030-31 based on council Financial Plans.

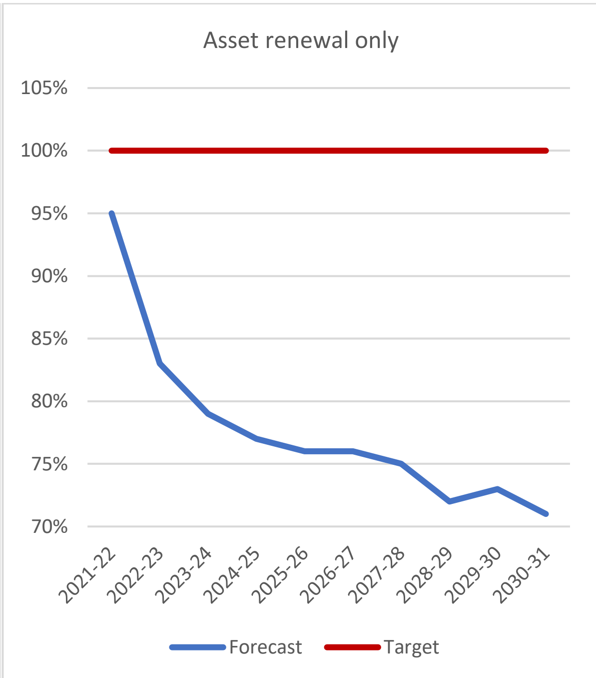




The adjusted underlying result graph shows a significant recovery from a deficit of -3.5 % in 2021-22 to 0% in 2022-23 and then an upward trend over the latter years to 1.6% in 2030-31. The 2021-22 year reflects the forecast impact of COVID-19.

The unrestricted cash graph shows a forecast decline from 94% in 2021-22 to 76% in 2025-26 and then an upward trend over the latter years to 96% in 2030-31.





The asset renewal (including upgrade) graph shows a forecast decline from 137% in 2021-22 to 90% in 2030-31. The asset renewal (excluding upgrade) graph shows a forecast decline from 95% in 2021-22 to 71% in 2030-31, well below the LGPRF accepted target of 100%.

Note: The above financial results are based on the 2021-31 Financial Plans of Victorian local governments adopted in the 2021 year. They exclude the full impacts of COVID-19 and the significant increase in the consumer price index in the 2022 year.

5. Sustainability gap

This section considers the sustainability gap which has begun to emerge since the introduction of the rate cap in 2016-17 to 2020-21.

The LGPRF defines sustainability as local governments having the capacity to meet the agreed service and infrastructure needs of their community and absorb foreseeable changes and unexpected shocks into the future. The sustainability gap therefore is the cumulative effect of not achieving sustainability as defined above. The three areas contributing to the sustainability gap are:

- Rate cap is less than changes in the local government cost base
- Asset renewal is less than depreciation
- Unrestricted cash is diminishing.

The following observations and comments are based on the financial analysis in the previous sections.

5.1 Rate cap

Observation

The local government cost base for the sector measured in terms of gross expenses, expenses excluding depreciation/amortisation and expenses per assessment have all exceeded the rate cap in all years since rate capping was introduced in 2016-17. On a cumulative basis for the four years following 2016-17 and using expenses per assessment as the measure, the gap between the cost base increase and the rate cap was 4.0% for the sector with the gap for interface councils and small rural councils being 11.1% and 9.0% respectively.

The impact of the above, is that since 2016-17 the underlying surplus for the sector has been eroded over time as the annual increase in expenses has outstripped the increase in operating revenues. Except for metro councils, all cohorts experienced underlying deficits in 2019-20 with only regional cities recovering to achieve a surplus in 2020-21. Small and large rural councils have achieved underlying deficits since 2017-18 with small rural councils experiencing a significant downward trend. Except for metro and interface councils, all cohorts are forecast to have underlying deficits by 2025-26.

Comment

The rate cap is not representative of changes in the local government cost base. As pressure continues to grow on the operating costs of the sector due to inflationary pressures and the expected growth in wages, the gap between the rate cap and changes in the cost base will only widen over time. To remain viable over the long term, Councils will need to reduce services and/or capital works.

5.2 Asset renewal

Observation

Since 2016-17 capital works for the sector has increased from $2.2 billion to $2.9 billion in 2019-20 and then decreased to $2.8 billion in 2020-21. Metro councils have accounted for most of the capital works increase with other cohorts experiencing smaller increases.

Despite the above, between 2016-17 and 2020-21 asset renewal for the sector has totalled $5.8 billion compared to total depreciation of $7.7 billion resulting in an asset renewal gap of $1.9 billion over the five year period. All council cohorts are forecast to have asset renewal levels less than depreciation from 2022-23.

Comment
Councils are not funding their asset renewal needs which will result in higher maintenance costs, lower asset service standards and the potential for asset failure. As funds are redirected to address the imbalance between the local government cost bases increases and the rate cap, the asset renewal gap will only continue to grow.

5.3 Unrestricted cash

Observation
Since 2016-17, cash and investments for the sector has increased from \$4.5 billion to \$6.9 billion. When you consider the composition of cash and investments, only \$3.8 billion or 55% was unrestricted in its use in the 2020-21 year. The other \$3.1 billion represented monies being held for developer contributions, incomplete capital work projects and other external commitments. Unrestricted cash is forecast to decline over the next 5 years with metro councils and regional cities expected to have unrestricted cash levels close to the LGPRF target of 50% by 2025-26.

Since 2016-17 borrowings for the sector has decreased from \$1.2 billion to \$1.0 billion in 2019-20 and then increased to \$1.1 billion in 2020-21. Except for regional cities, all cohorts experienced decreasing levels of debt over the five year period. Debt levels are forecast to peak at 27% of rates and charges in 2022-23 followed by a decline to 23% by 2025-26 compared to the LGPRF target of 60%. Regional cities are forecast to have the highest debt levels at 42% by 2020-21 and expected to remain at that level over the next five years.

Comment
Councils have reasonably strong balance sheets but as unrestricted cash declines, discretionary expenditure will also decline. This will leave councils with limited capacity to invest in services and infrastructure to meet the needs and aspirations of its communities. Councils have relatively low levels of debt so new infrastructure can be funded from debt in the medium term. However, debt is not a finite funding source and with interest rates expected to continue rising to address inflationary pressures, debt servicing costs will also rise and compete for funding.

5.4 Long term viability

Observation
For the 10 year forecast period of 2021-22 to 2030-31 the sector's adjusted underlying result is forecast to recover from a COVID-19 impacted deficit in 2021-22 to a small surplus in 2030-31. Unrestricted cash is forecast to increase from \$2.5 billion in 2021-22 to \$2.8 billion in 2030-31. Asset renewal including upgrade expenditure is forecast to decline from \$2.3 billion in 2021-22 to \$2.1 billion in 2030-31. While asset renewal excluding upgrade is forecast to increase marginally from \$1.6 billion in 2021-22 to \$1.7 billion in 2030-31. Over this time depreciation is forecast to increase from \$1.7 billion to \$2.4 billion with a resulting asset renewal only gap over the period of \$4.7 billion.

Comment
The long term forecasts indicate that councils are remaining viable by reducing investment in asset renewal expenditure relative to depreciation. The long term forecasts also exclude the impact of rising inflation with councils setting future rate cap and cost base increases based on the consumer price index (CPI) of 1.1% for the 12 months to March 2021. CPI currently sits at 6.1% for the 12 months to June 2022. The revised financial plans are expected to show underlying deficits over the long term as the gap between the rate cap and cost base increases widen. This will be exacerbated as enterprise agreements are renegotiated and predicted wage growth impacts flow through to the cost base.