fiscal★star
rating local government

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Financial Sustainability Assessment Methodology

This note outlines the methodology used by FiscalStar for the 2009 financial sustainability review of NSW councils undertaken in conjunction with *Review Today*.[1]

Ratings scale

FiscalStar's assessment of the financial sustainability of a council's existing financial and infrastructure policies uses the following scale:

- **Sustainable**, also denoted as "S";
- **Vulnerable**, also denoted as "V"; and
- **Unsustainable**, also denoted as "U".

A council's *existing* financial and infrastructure policies are assessed as financially **sustainable** only if any present financial and infrastructure imbalances[2] could be eliminated – and the council's financial and infrastructure conditions brought to prudent and responsible levels – without resorting to substantial revenue-raising (and/or expenditure) adjustments.

By contrast, a council's *existing* financial and infrastructure policies are assessed as financially **unsustainable** where substantial revenue-raising (and/or expenditure) adjustments by the council seem unavoidable over the next few years.

Whether a council's *existing* policies are financially 'sustainable' or 'unsustainable' therefore depends upon whether the adjustments necessary to those policies qualify as '**substantial**' or not.

The focus is on a council's policy sustainability

FiscalStar's assessments focus on the financial sustainability of a council's financial and infrastructure policies – or '**policy sustainability**' for short.

Hence, what is 'unsustainable' are the council's existing **policies**, both revenue-raising and spending. A council's finances can always be corrected with substantial rates increases and/or expenditure cutbacks, but at a considerable cost to ratepayers and the community.

FiscalStar's particular focus is on a number of key aspects of a council's financial and infrastructure policies, namely:

- the council's revenue-raising effort, and so its key **funding policy** decisions (and the level and annual % growth of a council's property rates, annual charges, fees, fines and user charges);
- the council's **spending on services policy**, and in particular the extent to which its on-going annual % expenses growth (on a per assessment basis) matches or exceeds the underlying annual % increase in unit costs;
- the council's **spending on assets policy**, and in particular the extent to which the council's actual annual spending on renewal and replacement of existing infrastructure assets matches or falls short of required expenditure; and
- the council's **financing policy**, and so the level and mix of borrowing (new debt) and internally-generated sources (ratepayer-contributed equity) when it comes to financing the acquisition of both additional and replacement assets (and so the sourcing of capital employed by a council).

[1] This note was issued in March 2009. It replaces all previous versions of this note.

[2] Financial and infrastructure imbalances involve a council's operating deficit, infrastructure backlog and/or net financial liabilities presently being in excess of levels considered prudent and responsible over the long term.

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A council's financial solvency or creditworthiness is not being questioned

If a council's existing policies are assessed as being financially 'unsustainable', the council's financial solvency or creditworthiness is not being called into question. **A financial sustainability assessment says nothing about the extent to which a council can meet its debt service obligations and avoid bankruptcy**. Because councils possess the power to impose a tax in the form of annual property rates, and ratepayers are bound to meet all outstanding obligations under the Local Government Act, there can be no doubt that councils are able to meet their debt service obligations.

Indeed, financial sustainability represents a **higher hurdle** than financial solvency. Being financially sustainable means that the relative stability and predictability of the council's rates, fees & charges are not at risk and the council's ratings burden is being shared fairly between present and future ratepayers (i.e., today's problems are not being left largely for future ratepayers to fix).

The focus is a council's existing policy and so its present policy settings

The assessment made of a council's existing policies relates to the council's **present policy settings**, not to its planned or future policy settings.

Until policy changes are evident in a council's actual financial and infrastructure conditions, the certainty and extent of any planned policy changes remain unknown. Only the council's present policies, as embodied in its most-recent statutory financial reports, can be known for sure from public sources – and be assessed by FiscalStar for their financial sustainability.

The focus is on predicting whether necessary policy changes are 'substantial'

Finally, FiscalStar's assessments do not involve predicting what a council's financial and infrastructure conditions will be like in 5-10 years' time. FiscalStar's assessments assume that each council's finances and infrastructure will in time reach – and be maintained at – prudent and responsible levels.

Rather, the focus is on each council's **present** financial and infrastructure conditions, and so on the likely magnitude of the **adjustments necessary** to existing policies over the next 5-10 years if the council's financial and infrastructure conditions are to reach – and be maintained at – prudent and responsible levels over such a time frame.

This focus on a council's **most recent** financial and infrastructure conditions (as well as on the continuation of **existing** expenditure policy and **existing** revenue-raising effort) is not to suggest that a council, facing poor or deteriorating financial and infrastructure conditions, will neglect either to adjust its expenditure policies or to lift its revenue-raising effort. On the contrary, the 'continuation of existing policies' assumption is a standard analytical device that enables the **size of the existing policy adjustment task** (if any) facing each council to be quantified.

In fact, the financial sustainability assessments are intended to flag the likely consequences of any necessary policy adjustment (compared with continuation of existing policy). Ratepayers of councils whose existing policies are assessed as financially 'unsustainable' face substantial rates/prices hikes or drastic services cutbacks (or both) as the financial and infrastructure problems facing those councils are addressed. It is these policy adjustments – rather than any suggestion of ongoing or burgeoning operating deficits or infrastructure backlogs – that will be the main symptoms in future of a council's existing policies being financially 'unsustainable'.

Key indicators

At the core of FiscalStar's financial sustainability assessment for a council are:

- whether the council has an **operating deficit**, and how large that deficit is; and
- how large the council's outstanding financial and infrastructure obligations are, encompassing both its **net financial liabilities** and any **infrastructure backlog**.

A council's **operating deficit ratio ("OD ratio")** summarises its operating statement performance. FiscalStar expresses the operating deficit as a % of the council's annual revenue from rates, fees & charges. The operating deficit is measured as the total of a council's annual underlying expenses less the total of its annual operating revenue.[3]

When it comes to summarising a council's balance sheet condition, FiscalStar's focus is on what it terms the **broad liabilities ratio ("BL ratio")**. FiscalStar expresses any broad liabilities as a % of the council's total annual operating revenue.[4]

Broad liabilities are measured by the sum of a council's net financial liabilities and an estimate of its infrastructure backlog. In turn:

- **Net financial liabilities** is measured by the council's total liabilities less its financial assets. Financial assets include (i) holdings of cash, cash equivalents and investments/securities not subject to any external restrictions, (ii) any restricted cash, cash equivalents and investments/securities matching restricted liabilities, and (iii) all receivables, both current and non-current.
- The **infrastructure backlog** is the estimated total cost of undertaking the required maintenance and renewal that the council's asset managers had programmed to occur during the year in question or in preceding years, but which were not carried out (due to a lack of finance or other reasons) and are still required to be done. The 'backlog' relates to buildings, roads and all other infrastructure assets (including drainage assets, recreational assets and natural assets).

FiscalStar considers an infrastructure backlog in effect to be a 'liability' facing a council much like borrowings but one that does not show up on a council's balance sheet. Hence, a council's BL ratio summarises its 'true' balance sheet condition.

Core assumptions

To evaluate a council's OD and BL ratios, FiscalStar makes two sets of judgments.

First, for a council's financial and infrastructure conditions to be considered **prudent and responsible**, FiscalStar assumes that the council must be running a slight operating surplus,[5] have a zero infrastructure backlog and its net financial liabilities levels must be no more than would assure at least a single-A stand-alone credit rating.[6] The further away a council's present financial and infrastructure conditions are from these prudent and responsible conditions, the greater the adjustments that can be reasonably expected in future to the council's policy settings.

Secondly, to judge whether any policy adjustments qualify as '**substantial**' in nature, FiscalStar focuses on the annual % increases in a council's rates, fees & charges (per assessment) necessary in order that any present financial and infrastructure imbalances be phased out over a 10 year period. If the annual % increase in a council's rates, fees & charges necessary on average for 10 years is more than **double the annual inflation rate**, the associated policy adjustments are judged to be

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[3] This definition of the operating deficit (which is before capital revenues are taken into account) differs from the measure sometimes headlined by councils themselves measured after capital revenues are taken into account. As has been demonstrated by Access Economics, any operating deficit which is measured after capital revenues are taken into account understates the council's 'true' operating deficit for the purposes of shedding light on whether the council's ratings burden is being shared fairly between present and future ratepayers.

[4] The different revenue denominators in the OD and BL ratios can be explained as follows. The denominator chosen for the OD ratio (annual revenue from rates, fees & charges) involves only the operating revenue that is under a council's direct control, so that the resultant ratio provides an indication of the % change necessary in such revenues were any deficit to be eliminated. By contrast, the denominator chosen for the BL ratio encompasses all operating revenue (i.e., not only annual revenue from rates, fees & charges but also grants from other governments as well as other own-source operating revenue) because the source of a council's revenue – whether by its own effort or from other governments – is immaterial when it comes to assessing the 'burden' imposed by the council's outstanding financial and infrastructure obligations.

[5] A minimum 2½% operating surplus is considered necessary otherwise infrastructure enhancements will have to be financed largely by debt which has the effect of shifting too much of the funding burden onto future taxpayers to the detriment of intergenerational equity.

[6] FiscalStar assumes that NSW councils would generally be assured of at least a single-A credit rating on a 'stand-alone' basis (i.e., a credit rating that discounts any implied State government guarantee) provided a council's net financial liabilities do not exceed 60% or so of its annual operating revenue. For most councils, their present net financial liabilities ratios are 20% or less.

'substantial'.[7] Any average annual % increase necessary over 10 years that is below this threshold but is still **greater than 1⅔ times the annual inflation rate** is judged to run the risk of becoming substantial were unexpected developments to occur. On this basis, in FiscalStar's judgment:

- a council's existing policies are considered to be financially **unsustainable** if the council's present financial and infrastructure imbalances could be eliminated only by 10 years' worth of annual % increases in rates, fees & charges of **in excess of 2 times annual inflation** on average;
- a council's existing policies are considered to be financially **sustainable** if the council's present financial and infrastructure imbalances could be eliminated by 10 years' worth of annual % increases in rates, fees & charges at **less than 1⅔ times annual inflation** on average;[8] and
- if a council's existing policies are somewhere between financially 'sustainable' and financially 'unsustainable', they are considered to be **vulnerable**.[9]

Benchmarks

FiscalStar shows its benchmark OD and BL ratios for a council using a **criteria chart**. Chart 1 provides an illustrative criteria chart. Such charts provide an indication of FiscalStar's estimates of the various OD and BL ratio combinations for a council that would fall into each of the financial sustainability categories.

FiscalStar's criteria chart has:

- two **axes**, one for each of the two summary indicators of a council's present financial and infrastructure conditions, namely the council's OD ratio and its BL ratio; and
- a number of **zones**, each indicating OD and BL ratio combinations which FiscalStar assesses to be of similar merit from a financial sustainability perspective.[10]

Specifically, the coloured zones in the criteria chart distinguish between:

- all OD and BL ratio combinations deemed to be financially **sustainable** – the **green (or S) zone**;
- all OD and BL ratio combinations deemed to be financially **vulnerable** – the **amber (or V) zone**; and
- all OD and BL ratio combinations deemed to be financially **unsustainable** – the **red (or U) zone**.

A closer look at Chart 1 shows that if a council (with characteristics similar to those underlying that chart) has a **zero BL ratio**, other things being equal its existing policies would be assessed as being:

- financially 'sustainable' if its most-recent OD ratio was below 10%;
- financially 'vulnerable' if its OD ratio was between about 10% and 22%; and
- financially 'unsustainable' if its OD ratio was above 22%.

However, these particular OD ratio benchmark values apply only to a council with a zero BL ratio.

As the criteria chart also shows, each of these benchmark values are reduced in value if a council's BL ratio is greater than zero. Moreover, the higher a council's BL ratio, the greater is the reduction necessary to each of these benchmark values.[11]

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[7] If annual inflation were to average 3%, this would involve annual increases in a council's (per assessment) revenue from rates, fees & charges averaging at least 6%.

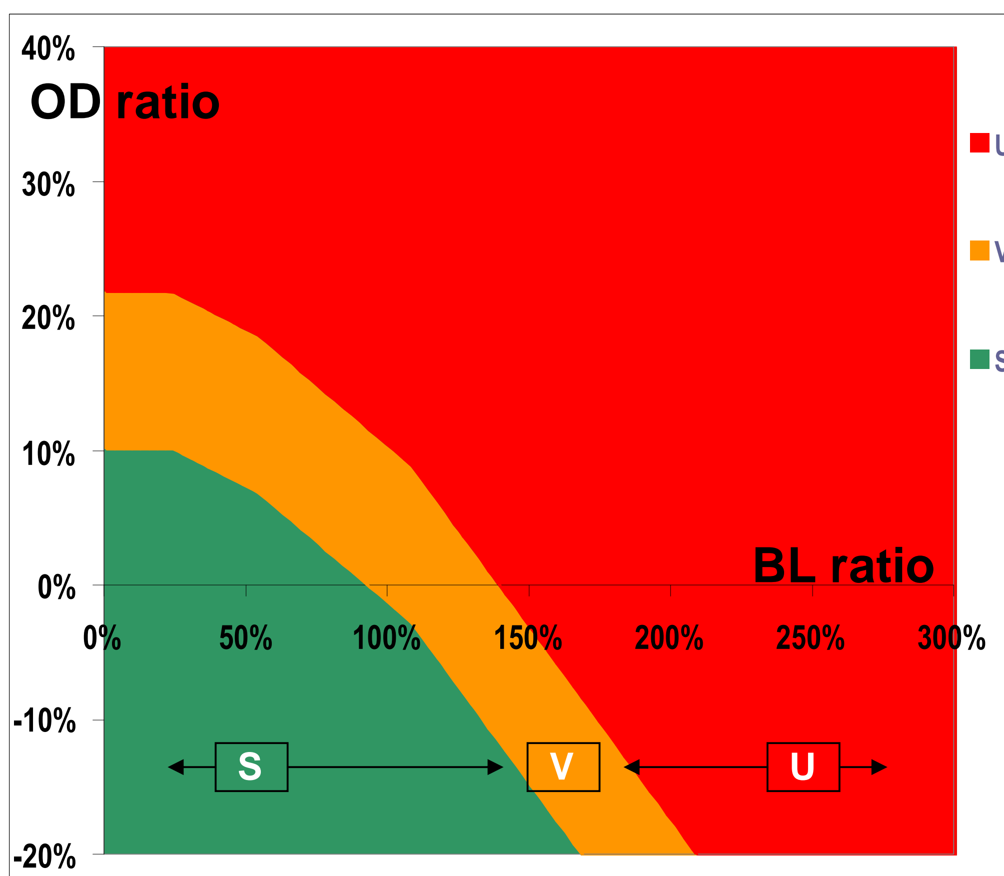
[8] This would involve annual increases averaging less than 5% were annual inflation around 3%.

[9] These are councils whose present financial and infrastructure imbalances could be eliminated by 10 years' worth of annual increases in rates, fees & charges averaging between 1⅔ and 2 times annual inflation.

[10] More specifically, each zone contains all OD and BL ratio combinations where the annual % increases in rates, fees & charges necessary on average over a 10 year period to eliminate present financial and infrastructure imbalances are within a specified range of increases.

[11] For example, if a council (with characteristics similar to those underlying the chart) has a BL ratio of 100% (other things being equal), its existing policies would be assessed as financially 'sustainable' if its most-recent OD ratio was below -2% (i.e., an operating surplus ratio greater than 2%); its policies would be assessed as financially 'vulnerable' if its most-recent OD ratio was between about -2% and 11%; and its policies would be assessed as financially 'unsustainable' if its most-recent OD ratio was above 11%.

CHART 1
Illustrative Criteria Chart**



**This particular chart applies only to councils with (i) financial characteristics (other than their OD and BL ratios) at about the State-wide average, (ii) existing operating expenditure and asset management policies that neither increase nor decrease the council's present OD and BL ratios (other things being equal), and (iii) depreciable assets that are presently valued on a current cost – rather than historical cost – basis.

The use made of the criteria chart can be illustrated further with an example. Consider the example shown in Chart 2 below involving a council with:

- a **present** (or "actual") combination of an OD ratio of 15% and a BL ratio of 120%; and
- a **target** combination of OD and BL ratios involving a 2½% operating surplus (i.e., an OD ratio = -2½%) and a BL ratio of 60%.

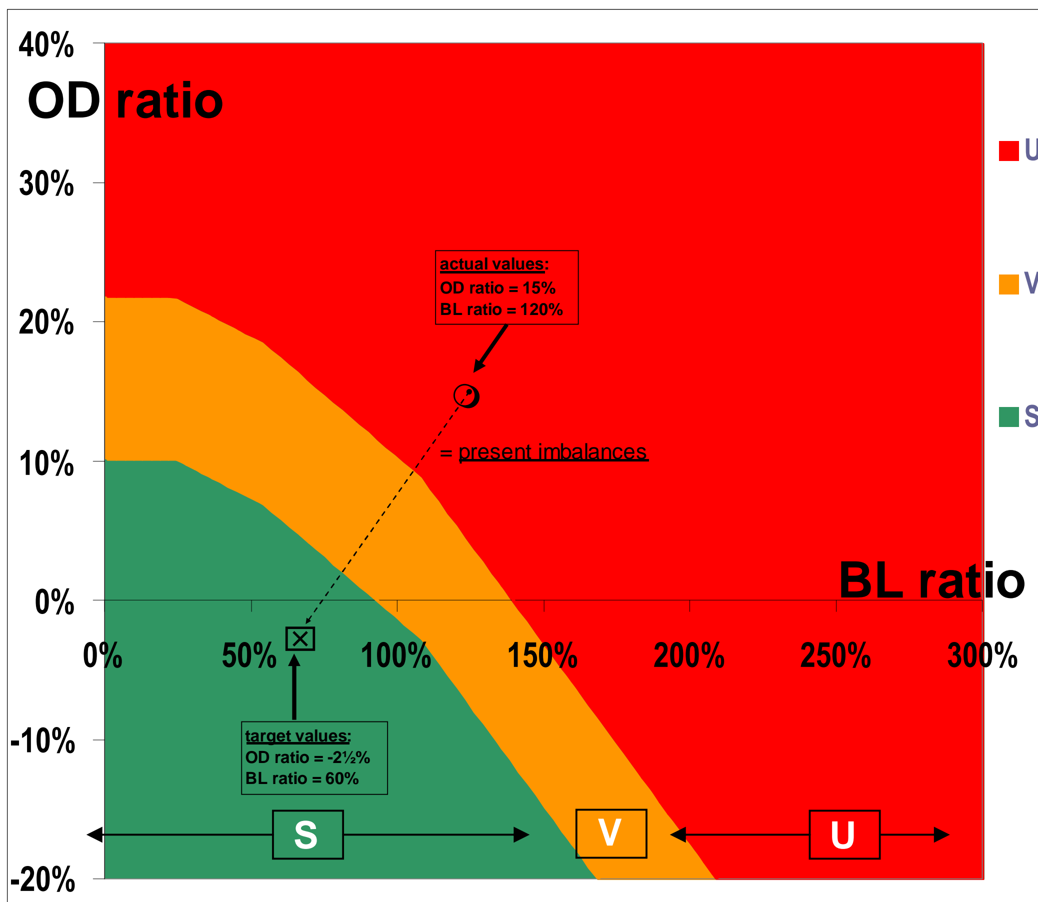
The chart puts this illustrative council in the red zone, meaning that the council's existing policies would be assessed by FiscalStar as being financially 'unsustainable' (or "U").

This indicates that, in order to move the council's financial and infrastructure conditions from (i) its present combination of OD and BL ratios (15% OD and 120% BL) to (ii) the target OD and BL ratios (-2½% OD ratio and 60% BL ratio), **'substantial'** annual % increases in the council's rates, fees & charges would be necessary.

In effect, these criteria charts show that the financial sustainability assessment is primarily about obtaining the most accurate and up-to-date measurement, for each council, of a council's OD and BL ratios.

Once these two ratios are appropriately measured, the assessment of the financial sustainability of a council's existing policies is a matter of plotting the corresponding point (being the council's most-recently observed combination of OD and BL ratios) on the relevant criteria chart, and reading off the financial sustainability assessment (S or V or U) by reference to the corresponding zone.

CHART 2
Illustrative Criteria Chart; Example Council**



**This particular chart applies only to councils with (i) financial characteristics (other than their OD and BL ratios) at about the State-wide average, (ii) existing operating expenditure and asset management policies that neither increase nor decrease the council's present OD and BL ratios (other things being equal), and (iii) depreciable assets that are presently valued on a current cost – rather than historical cost – basis.

Role of a council's other financial characteristics

The positioning of the various colour zones in the criteria charts used by FiscalStar, and so FiscalStar's benchmarks for each council, differs according to (i) a council's financial characteristics (other than their OD and BL ratios), (ii) the council's existing expenditure policies, and (iii) whether the council's depreciable assets are presently valued on a 'current cost' versus 'historical cost' basis.[12]

What this means is that even if two councils presently have identical OD and BL ratios, the revenue and spending adjustments that each might need to apply over time in order to eliminate any present financial and infrastructure imbalances will differ depending on, most notably:

- the council's relative revenue discretion (or, put conversely, its **grants dependency**), as measured by its annual revenues from rates, fees & charges as a % of its total annual operating revenue,
- the council's present **annual expenses growth gap**, being the gap between (i) its actual annual % expenses growth (on a per assessment basis) and (ii) the underlying annual % increase in unit costs;

[12] Planned revenue policy changes are not factored-in to FiscalStar's assessments because the whole aim of the exercise is to establish the extent to which revenue-raising effort adjustments – whether planned or unplanned – are necessary in future if a council is to achieve prudent and responsible outcomes for its operating deficit, infrastructure backlog and net financial liabilities.

- the council's present **annual renewals gap**, being the gap between (i) its **required** annual renewals expenditure and (ii) the council's **actual** annual spending on renewals; and
- the proportion of the council's depreciable assets presently valued on a **'fair value'** – rather than historical cost – basis.

A council has **more degrees of financial freedom** (and so can tolerate higher OD and BL ratios, other things being equal):

- the **lower** is its grants dependency;[13]
- the **lower** is the on-going annual % growth in its expenses (on a per assessment basis) inherent in its existing policy;[14]
- the **greater** is the actual annual spending on renewals (and rehabilitation) inherent in its existing policy;[15] and
- the **higher** is the proportion of its depreciable assets presently valued on a 'fair value' – rather than historical cost – basis.[16]

Put in terms of the criteria charts, the lesser are a council's degrees of financial freedom (for example, the relatively greater is its grants dependency or the relatively greater the annual % growth in its expenses), the larger the red (or U) zone and the smaller the green (or S) zone.

In cases where a council's present combination of OD and BL ratios is close to the boundary between two of the zones shown in the criteria chart, this shift may be enough to tip such councils either (i) from the green (or S) zone into the amber (or V) zone, or (ii) from the amber (or V) zone into the red (or U) zone.

For example, compare the charts in each panel of Chart 3 below. Panel A illustrates the positioning of the various zones for a council with very favourable financial characteristics apart from its OD and BL ratios, whereas Panel B illustrates the positioning of the zones typical for a council with much less favourable other financial characteristics.

Consider a council presently exhibiting a 0% OD ratio and a 100% BL ratio. If the council's other financial circumstances were as illustrated in Panel A, its existing policies would be assessed as being financially 'sustainable'. If, on the other hand, the council's other financial circumstances were as illustrated in Panel B, its existing policies would be assessed as being financially 'unsustainable'.

Each council therefore has a unique criteria chart based on its own financial characteristics. Councils are provided with their own criteria chart.

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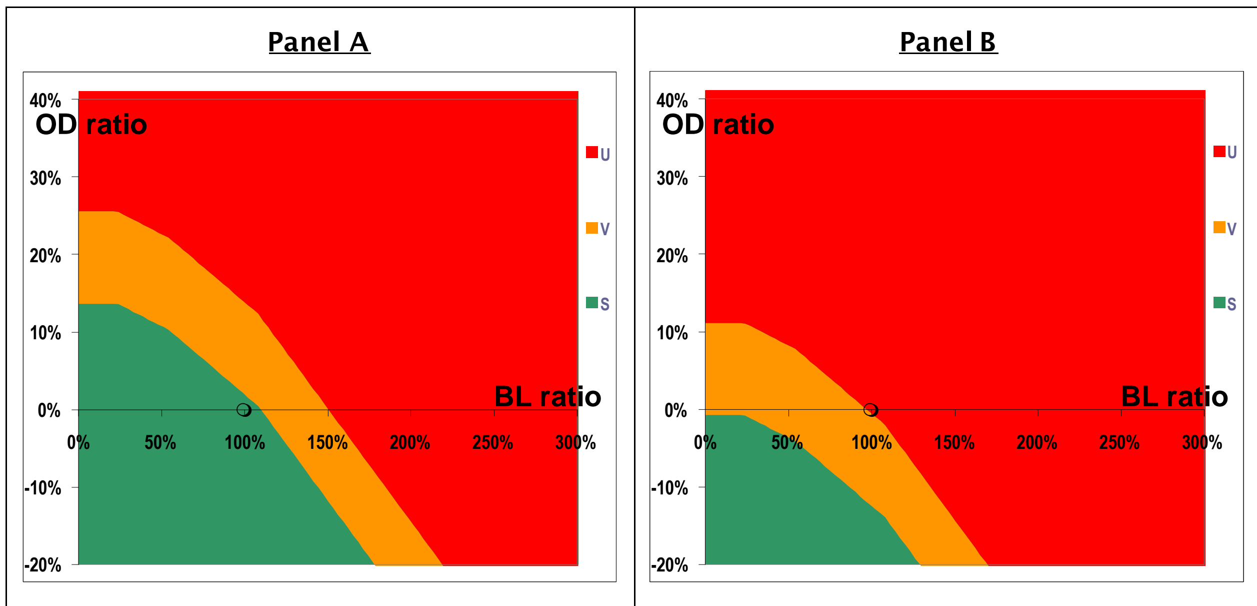
[13] The lower is a council's grants dependency, the more the amount of revenue that will be generated by a given annual % increase in its rates, fees & charges, and so the more significant the inroads possible into any present financial and infrastructure imbalances. Alternatively, the greater a council's grants dependency (other things being equal), the greater the annual % increase that will be needed in its rates, fees & charges in order to eliminate any present financial and infrastructure imbalances.

[14] The greater the amount by which a council's annual % expenses growth (on a per assessment basis) under existing policy falls short of the underlying annual % increase in unit costs, the more likely the council's OD ratio will fall over time under continuation of existing policy. Alternatively, the more a council's annual % expenses growth (on a per assessment basis) under existing policy exceeds the underlying annual % increase in unit costs (other things being equal), the more likely the council's OD ratio will rise over time under continuation of existing policy.

[15] The greater the amount by which a council's actual annual spending on renewals and rehabilitation exceeds the required level of annual spending, the more likely the council's BL ratio will fall over time under continuation of existing policy. Alternatively, the more a council's required level of annual spending on renewals exceeds its actual annual spending (other things being equal), the more likely the council's BL ratio will rise over time under continuation of existing policy.

[16] The higher the proportion of a council's depreciable assets which are presently valued on a 'fair value' – rather than historical cost – basis, the less the council's OD ratio will rise over time as its assets are increasingly valued on a 'fair value' basis and annual depreciation charges increase as a result (other things being equal). Alternatively, the more that a council's depreciable assets are presently valued on an historical cost basis, the more the council's present OD ratio is likely to underestimate the OD ratio expected as 'fair value' asset valuation is rolled out across local government in NSW.

CHART 3
Illustrative Criteria Charts: Effect of Other Financial Characteristics



Comparison with the 2008 methodology

Two sets of minor refinements are evident since the 2008 assessments, both of which relate to measurement changes to some of the key indicators used.

First, the methodology now places sole emphasis on a council's **net financial liabilities** in place of the previous separate treatment of the narrower 'long-term debt' and 'spare cash balances' concepts. As a result, the methodology now also recognises current debt and other liabilities such as employee entitlements and other provisions, and payables. In addition, the contentious issue of what constitutes 'spare' cash balances is avoided, with net financial liabilities encompassing all available financial assets.[17]

Secondly, where separately reported, the infrastructure backlog ratio is now measured using the replacement value of a council's infrastructure assets (including buildings) as the ratio's denominator.[18],[19] The broad liabilities ratio ("BL ratio") remains the sum of a council's net financial liabilities and infrastructure backlog *amounts* expressed as a % of the council's annual operating revenue. Thus:

$$\text{BL ratio} = \text{NFL ratio} + [\ \text{IB ratio} * (A/O)\ ]$$

where

NFL ratio = net financial liabilities as a % of annual operating revenue (O)

IB ratio = infrastructure backlog as a % of the replacement value of existing infrastructure assets (A)

A = the replacement value of existing infrastructure assets

O = annual operating revenue.

Together, these minor refinements serve to simplify exposition of FiscalStar's methodology.

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[17] FiscalStar measures financial assets as the sum of (i) holdings of cash, cash equivalents and investments/securities not subject to any external restrictions, (ii) any restricted cash, cash equivalents and investments/securities matching restricted liabilities [as the latter are counted in total liabilities], and (iii) all receivables, both current and non-current.

[18] Previously, the backlog ratio was measured using a council's annual operating revenue as the denominator.

[19] FiscalStar proxies the replacement value of an asset by reference to the asset's gross carrying value adjusted, where necessary, onto an approximate 'fair value' basis.