3.1 Implementation of the Local Government Act 2002 and the Local Government (Rating) Act 2002

3.101 Local authorities are dealing with large-scale change in their legislative framework as a result of a number of legislative amendments, in particular with the passing in 2002 of the new Local Government Act and the Local Government (Rating) Act.

3.102 The Local Government Act 2002 introduces a comprehensive planning and reporting regime. This regime builds on the provisions of the Local Government Act 1974 by introducing new elements that underscore the need for reliable and relevant information to support elected members and communities in decision-making. One new element – the long-term council community plan (LTCCP) – will require significant work by local authorities to develop the supporting policies and information by 2006 when the new Act comes fully into effect.

3.103 The Local Government Act 2002 also establishes new accountability and public consultation requirements for use of the rating mechanisms under the Local Government (Rating) Act 2002. The financial year 2003-04 will be the first in which local authorities will levy their rates under the new Rating Act. Many of these changes have required local authorities to undertake extensive preparation in anticipation of the Local Government (Rating) Act coming into force.

3.104 Because of the magnitude of the changes required as these two Acts come into effect, our audit focus during 2003-04 will be in three areas:

- specific new legislative compliance requirements;
- the current state of councils' planning and reporting information; and
- providing information where our auditors and the sector may require guidance in the future.

3.105 We have selected three elements from the Local Government Act 2002 for particular focus:

- service levels;
- asset management information; and
- significance policies.

3.106 From the Local Government (Rating) Act 2002, we will be focusing on:

- the rating cap;
- new policy requirements; and
- the funding impact statement.

3.107 We will be formulating our expectations for the reporting of performance information by councils under the new Local Government Act. We will do this in part while determining our approach to the audit of LTCCPs – which we will audit with effect from 2006. We will also be formulating our own understanding of, and capability to audit, sustainable development reporting.

Local Government Act 2002

Service Levels

3.108 In recent reports to Parliament, we have expressed our concern that, in some cases, asset management plans were lacking service level information, or that expectations about service levels had not been established from a public consultation process.[1]

3.109 The Local Government Act 2002 requires local authorities in their LTCCPs to specify service levels, and performance measures and targets against which services can be assessed for groups of activities:

- in detail for the first three years; and
- in outline for subsequent years.

1 See, for example: *Local Government: Looking Back and Looking Forward*, parliamentary paper B.29[02a] 2002, page 30; and *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a] 2001, page 14.

3.110 Ideally, there should be a clear rationale for a local authority's choice to be involved in an activity or group of activities, and a link between this rationale and the service levels and performance measures.[2] This link will develop over the next 2-3 years as local authorities facilitate identification of community outcomes, as required of them on behalf of their communities by the Local Government Act 2002.

Asset Management Information

3.111 A number of our reports to Parliament over the last decade have commented on asset management by local authorities, highlighting the importance of quality information for preparing reliable estimates.[3]

3.112 To enable communities to have confidence in the information and proposals contained in LTCCPs, the Act contains a number of requirements about asset information.

3.113 Based on feedback from our auditors, we believe that:

- many councils' asset management systems have not been significantly developed since their adoption (following the 1996 Local Government Act amendments); and
- some councils may not be continuously maintaining and updating asset management information.

3.114 Our intention is to evaluate the current state of councils' asset management plans to ensure that reliable asset information supports the LTCCPs.

Significance Policy

3.115 The Local Government Act 2002 provides local authorities with considerable scope for discretion about their activities within the statutory purposes and powers. This discretion is to be exercised through demanding planning, reporting, and accountability requirements. The concept of "significance" is central in these requirements and to the purpose of local government.

2 For further suggestions about performance information, see our publication *Reporting Public Sector Performance*, ISBN 0-477-02877-2, 2002.

3 *Local Government: Looking Back and Looking Forward*, parliamentary paper B.29[02a] 2002, page 28; and *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a] 2001, pages 11-17.

3.116 We have previously reported on the approach of local authorities to the term "significant", because the Local Government Act 1974 placed reliance on the exercise of judgement by decision-makers and therefore on the need to consider significance.[4] We were surprised to find that most local authorities had not formulated any guidance for the public, councillors, or staff about what might be regarded as significant.

3.117 The Local Government Act 2002 defines "significance" and "significant" (section 5), to help local authorities direct the appropriate level of consideration and public disclosure and consultation to matters based on their relative importance to the district or region.

3.118 Local authorities are also required to adopt a significance policy that sets out:

- their general approach to determining significance; and
- any thresholds, criteria or procedures used in assessing the significance of any issue.

3.119 We will consider and report on the nature of local authorities' significance policies.

Local Government (Rating) Act 2002

The Cap on Targeted Rates and Uniform Annual General Charges

3.120 The Local Government (Rating) Act 2002 retains a 30 percent cap on the proportion that certain rates can comprise of a council's total rates revenue. This cap applies to:

- targeted rates that are –
  - calculated as a fixed dollar amount per rating unit or separately used or inhabited portion of a rating unit (and which is not used solely for water supply or sewage disposal); and
  - uniform for all properties to which the rate applies; and
- uniform annual general charges.

4 *Local Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[01a] 2001, pages 82-86.

3.121 While the cap is not new, the Local Government (Rating) Act 2002 introduces new, more flexible, rating tools. Calculation of the cap is, therefore, more complex. We will review local authorities' calculation of the rating cap, to assist them to avoid inadvertent breaches of the Act while they become familiar with the new requirements.

New Policy Requirements

3.122 The Act introduces several new policies that, by their adoption, allow councils to determine the circumstances under which they will forgo rating revenue or delay the receipt of this revenue. These policies are:

- rates relief for Maori freehold land;
- remissions;
- postponements; and
- early payments.

3.123 We are particularly interested in the postponements policy, which allows local authorities to defer the receipt of rates revenue. Some local authorities have indicated that they will consider using this policy to provide ratepayers with services such as reverse mortgages. As such a use of this policy could raise financial reporting issues in future years, we will be assessing policies adopted in the first year of the Act to identify best practice and potential risks.

Funding Impact Statement, and Analysis of General and Targeted Rates Proposed

3.124 The Funding Impact Statement is a link between certain requirements under the Local Government Act 2002 and requirements under the Local Government (Rating) Act 2002. It must be included in a local authority's LTCCP and also in its Annual Plan. The purpose of the Funding Impact Statement is to set out the funding mechanisms that a local authority will use, their level, and the reason for their selection in terms of the principles of financial management.

3.125 We will review each local authority's Funding Impact Statement to ensure that, for the rates proposed, the Statement contains the information from Schedule 2 and Schedule 3 of the Local Government (Rating) Act 2002. These schedules establish:

- the units of liability where a local authority is setting a general rate differentially under sections 13 and 14 of the Act; and
- factors for calculating the liability where a local authority is setting a targeted rate under sections 16-20 of the Act (targeted rates are similar to separate rates under the Rating Powers Act 1988).

3.126 We hope that, in future years, this information will allow us to assess the take-up and use of the more flexible rating powers provided through targeted rates.

3.2 Public-private Partnerships

3.201 Well-designed and well-managed public-private partnerships offer a means of managing the risks and cash flow requirements of large capital-intensive projects. The concept of such partnerships has gained momentum over recent years, as reflected by the provisions of:

- the Local Government Act 2002 – which requires councils to adopt a policy on partnerships with the private sector and include this as part of their LTCCP; and
- the Land Transport Management Bill – which is currently before Parliament and proposes greater flexibility to enable new roads and roading improvements to be built.

3.202 Because public-private partnerships are likely to involve long-term capital-intensive projects, they can pose significant financial and non-financial risks. As a result, public concerns have arisen about public-private partnerships – particularly internationally, but also in New Zealand.

3.203 Consequently, a range of considerations needs to be identified and managed in any public-private partnership – including:

- risk distribution between the council(s) and the private entity(ies);
- responsibilities, particularly where statutory responsibilities are involved;
- performance expectations of each other; and
- public accountability expectations.

3.204 Public-private partnerships also raise accounting issues about how assets, liabilities, revenues and expenses should be recognised between the participating parties, and the disclosures required to ensure an accurate reflection in the financial statements.

3.205 Councils need specifically to consider their accountability duties to the public in entering into and managing any public-private partnerships. They will need to be open and informative to communities about:

- the nature of any partnership;
- how a partnership came into being and why; and
- how the benefits envisaged are being realised through the project.

3.206 There is a broad public interest in ensuring that councils considering public-private partnerships have access to guidance about:

- issues to consider in forming partnerships; and
- management of the project and the relationship throughout the duration of the partnership.

3.207 We intend undertaking a project to identify and prepare best practice information. We will emphasise the New Zealand context both through local case studies and by drawing on international experience and best-practice lessons. We will also consider the treatment of public-private partnerships for accounting and reporting purposes.

3.3 The Balanced Budget Requirement

THREE

3.301 Under the Local Government Act 2002, local authorities are required to set each year's operating revenue at a level sufficient to meet operating expenses. However, the Act allows local authorities that have an LTCCP the discretion to vary from this principle, having regard to –

(a) *the estimated expenses of achieving and maintaining the predicted levels of service provision set out in the long-term council community plan, including the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life; and*

(b) *the projected revenue available to fund the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life; and*

(c) *the equitable allocation of responsibility for funding the provision and maintenance of assets and facilities throughout their useful life; and*

(d) *the funding and financial policies adopted under section 102.*[5]

3.302 This is a change from the Local Government Act 1974, which (since 1996) had contained a more prescriptive "balance the budget" requirement. We have reported on this more prescriptive requirement, particularly because of its effect that local authorities were required to cash fund the depreciation expense (subject to a few limited exceptions).

3.303 *"Depreciation" is the measure of the consumption of the economic benefits embodied in an asset whether arising from use, the passing of time or obsolescence.*[6]

5 Section 100(2).

6 Financial Reporting Standard No. 3 *Accounting for Property, Plant and Equipment* issued by the Institute of Chartered Accountants of New Zealand.

3.304 Requiring councils, as a rule, to balance the budget by setting operating revenues to cover projected operating expenses is appropriate within the accepted framework of prudent financial management. However, both local government and we have raised concerns over recent years about whether depreciation is (of itself) an appropriate tool for determining the level of funding to maintain local authorities' assets over the long term.

3.305 We have previously noted that –

Depreciation is not a proxy for the amount needed to fund local authorities' long-term asset requirements. Accounting for the past consumption of an economic benefit is not the same as providing for the full cost of services and assets in the future. These two purposes differ, and need to be considered separately.

In particular, revaluation of an asset and any reassessment of its remaining useful life result in recalculation of the depreciation charge (but do not necessarily indicate the funding needed for future service provision). The depreciation charge over the life of an asset will equal the renewal cost of the asset only by chance, especially if a revaluation or re-estimation of its useful life occurs.[7]

3.306 We are not convinced that it would always be financially prudent to cash fund the difference between the depreciation charge and the asset replacement amount in cases where the depreciation charge is greater than the funding estimated as necessary to replace assets in the future. Equally, there may be circumstances where a council projects a surplus but is not collecting sufficient funds because, for example, its assets are valued at historic cost. Under the Local Government Act 1974 there was no scope for councils to adjust their level of funding to recognise such circumstances.

3.307 The change effected by the 2002 Act presents an opportunity to consider whether there are circumstances under which cash funding of depreciation may generate more funding than is required for asset replacement. We therefore propose to undertake financial analysis to test this proposition and identify any circumstances in which cash funding only the asset replacement amount would be financially prudent. If such circumstances are identified, we will prepare guidance to assist our auditors in giving advice to councils about how to work within the more flexible balanced budget requirements of the 2002 Act.

7 *Second Report for 2000*, parliamentary paper B.29[00b], page 21.

3.308 The depreciation expense is material for most territorial authorities. Therefore, our intention is that the guidance that will flow from our analysis will promote resource management improvements by councils, while giving communities assurance – through LTCCPs – that rates and other charges are appropriate and will be adequate to ensure that services and facilities are provided over the long term.

THREE

3.4 Sharing of Services Between Local Authorities

3.401 For some time now, we have observed a variety of initiatives in the local government sector that are designed to ensure that resources are more effectively and efficiently used between groupings of local authorities. One example of this is where two or more councils work together to deliver a service to the public – that is, a "shared service".

3.402 Examples of shared services include:

- the pooling of regulatory staff between councils;
- development of common IT systems to allow for co-ordinated purchasing, maintenance and user support, and (consequently) a common interface with the public; and
- standardisation of processes – and the associated fees and charges – for common council services that are delivered in an area, such as dog licences and building inspection.

3.403 The Local Government Act 2002 recognises that local authorities may continue to engage in joint undertakings and co-operative activities.

3.404 We have decided to undertake a study of this topic to identify some of the potential benefits and lessons to be learned. Our preliminary view is that sharing services has the potential to bring about efficiency gains and to increase the effective use of resources by local authorities. Our study will also identify problems or difficulties associated with the concept and its application in practice.

3.405 While there is considerable debate on what constitutes a shared service, the focus of our study will be solely on public-to-public partnerships – i.e. between two, or a small group of, local authorities. We will not be examining public-private partnerships. (But see section 3.2 on pages 63-64.)

3.406 We have decided to undertake a case study approach to this work – similar to that adopted for our 2002 report, *Local Authority Involvement in Economic Development Initiatives – Choices for Successful Management*.[8] We intend to select a small number of shared service initiatives that are currently in operation for further study.

3.407 To provide background information for the study, we have written to all councils asking for details of any shared service initiatives that they have undertaken with other councils in their area. We said that we are interested in shared service initiatives that have been in operation for some period of time, as well as those that are at an early stage of implementation. We have also advised that we are interested where local authorities have undertaken no such initiatives – or have no initiatives planned – as this will give an indication of how widespread this type of activity is.

3.408 We intend to undertake the field work for this study later this year, with a proposed publication date of mid-2004.

8 ISBN 0-478-02896-9.