

TRENDS IN THE LEVEL OF LOCAL GOVERNMENT FUNDING AND EXPENDITURE

FINAL REPORT

Prepared for the Local Government Rates Inquiry

July 2007

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TRENDS IN THE LEVEL OF LOCAL GOVERNMENT FUNDING AND EXPENDITURE

Summary

Expenditure

Operating expenditure has increased significantly during the 1990's, with an increase of 47% over the last five years alone to June 2006. Operating costs have increased across all categories with costs associated with building and maintaining infrastructure having the biggest impact. The largest category of operating expenditure is the purchase of goods and services.

There is no evidence that significant cost increases are being caused by increases in employee costs. Employee costs are falling as a proportion of total operating expenditure and have been generally doing so since 1994 at least. One reason for this decline has been the contracting out of many operational functions such as road maintenance. In many cases these employee costs have been transferred to payments for goods and services by way of contract. Depreciation and interest costs are the fastest increasing operational costs. Depreciation expenses have increased as a proportion of total operational expenditure from 13% in 1994 to 21% in 2006 and are a major driver of increasing rates. Interest expenses have increased rapidly since 2004, but this is after years of declining costs as local authorities focused on debt reduction throughout the 1990's. Interest costs as a proportion of total operational expenditure more than halved between 1994 and 2004.

Operational expenditure is forecast to increase by 43% over the next 10 years, with larger increases concentrated in the first few years before levelling off. While this is considerably less than the 71% increase over the last 10 years it is still twice the level of general inflation. However local government services are expanding to cater for the growing population of New Zealand. Adjusted for the growth in households and inflation the increase per household reduces to less than 8%, under 1% real increase each year. The largest increases come from the metropolitan councils with some smaller councils forecasting real falls in expenditure.

The major drivers of forecast increases in expenditure are depreciation and interest costs. Depreciation costs are forecast to continue to rise as infrastructure investment increases and the sector moves towards fully funding depreciation costs. Interest costs increase as total debt more than doubles from \$4 billion in 2006/07 to \$8.2 billion in 2015/16. Total debt increases rapidly then levels out and is falling by the end of the forecast period. Transport investment accounts for 44% of capital expenditure over the 10 years to 2015/16, followed by the three waters at 29%, community facilities at 18% and other at 9%. The debt to assets ratio remains at a low 7% in 2015/16 despite this large increase. The 10 metropolitan councils account for over two thirds of this increased debt. Interest costs as a proportion of rates income rises to around 12%, well below the 20% level considered to be the prudent limit. By 2015/16 10 councils forecast no debt at all (all smaller rural councils or regional councils) while seven councils are forecasting interest costs to rate ratios over 20%.

Overall expenditure then is driven by significant investment in infrastructure, concentrated in large urban councils who then have to deal with increased maintenance, interest and depreciation costs.

Revenue

Local authority total operational revenue has increased substantially to fund the increasing expenditure needs, gathering pace with total operational revenue 40% higher over the past five years to June 2006. Rates income has increased at a slightly lower pace, growing by 37% over the same five year period. Councils have not been increasing rates faster than other income sources. Rates made up 56% of total operating revenue in the year ending June 2006, compared with 57% in the year ending June 1994. A note of caution; charges from Council Controlled Organisations are not included in this Rates series. Activities that used to be rates funded but are now funded through user pays will have shifted costs from rates to charges.

Taking into account inflation (consumers price index) total operational revenue has increased by 41% in real terms from June 1994 to June 2006, while rates have increased in real terms by 38%. This calculation of real increases is the same using both the Consumer Price Index (all sectors), or the Producer Price Index (Inputs - local government and civil defence series). In recent years prices impacting on local authorities have increased far quicker than the CPI. For example the prices of roadways and pipelines since 1998, as measured in the Capital Goods Price Index, have increased at around twice the rate of general inflation as measured by the CPI. These price increases have been a major driver in increasing operational expenditure. Without a high New Zealand dollar these impacts would have been greater.

The proportion of funding from central government has risen strongly since 2002. This series is largely road funding under the Financial Assistance Rate formula for local roads. As the price of maintaining and building the roading network has increased significantly recently, so to has the value of the central government contribution. While these central government funds have increased by 70% in the last five years these still only make up 12.7% of total operating revenue, up from 10.3% in the year ending June 1994.

Sales of goods and services and all other income make up around 20% of all operating revenue. This has increased rapidly in the last five years increasing 52%, much faster than previously.

Total operating revenue is forecast to climb 47% between 2006/07 and 2015/16. This is higher than the expected increase in operating expenditure and results in a substantial sector operating surplus of \$1.3 billion in 2015/16. This large surplus is utilised for capital expenditure, the building of reserve funds to replace assets in the future (depreciation) and/or the repayment of debt.

The forecast level of rates follows the operating expenditure trend but with a higher level of increases. Rates increases of around 8% a year in the next few years reduce to increases of around 4% a year. Rates are forecast to increase by 64% between 2006/07 and 2015/16. This will increase rates overall proportion of operating revenue from 54% in 2006/07 to 60% in 2015/16. This is effectively filling in the gap left by non-rate income growing at a slower rate than operating expenditure. Real rates per rateable property are forecast to increase by 23% from 2006/07 to 2015/16.

Rates are forecast to climb to almost 2.3% of GDP by 2011/12 before levelling off. This compares to ratios of below 1.9% in the years from 2000 to 2005 which were at historically

low levels. The forecast ratio indicates that rates are moving to a new level in the economy reflecting increased costs and higher levels of service in infrastructure.

The forecast increase in rates over the next 10 years appears to be related to the size of the council, the larger the council the greater the expected rates increase. The 10 metropolitan councils alone account for 58% of the increase in TLA rates to 2015/16. Smaller rural based councils are forecasting on average an increase in rates income of 41% over the next 10 years. The average rates per rateable property for metropolitan councils are currently higher than for provincial councils, which are higher than for rural councils. By 2015/16 the difference in average rates per rateable property is more pronounced. Possibly the larger councils are going through a catch up phase for past underfunding as well as providing for new infrastructure.

There are three main reasons for the difference in average rates per rateable property between large and small councils. First, larger councils tend to provide higher levels of service for recreation and cultural facilities. Secondly large councils often provide facilities and services that smaller councils do not provide at all (and these are often used by neighbouring smaller councils). Finally large councils have a much higher proportion of business properties and often have a differential in place that results in higher than average rates being levied on this type of property. This results in the overall average rates per rateable property figure being significantly higher than it is for residential properties only.

Forecast other revenue is not expected to keep pace with total revenue or operating expenditure, increasing by only 22% between 2006/07 and 2015/16. Other revenue as a proportion of total operating income falls from 42% in 2006/07 to 35% in 2015/16. As a result of this rates are forecast to increase faster in order to meet the required funding.

Councils across New Zealand, particularly those with higher growth rates, have moved to utilise new development contribution capital charges. With high growth rates and increasing infrastructure costs forecast by the metropolitan councils in particular, forecast development contributions show a massive increase. As a percentage of capital expenditure development contributions will increase from 7% in 2006/07 to 17% in 2015/16. This generates a risk as well as a welcome source of revenue. Councils have to invest in infrastructure in their communities if growth is expected and planned for, with development contributions paying for a significant proportion at the time of subdivision. If growth slows unexpectedly at any stage then ratepayers will end up carrying additional debt and interest costs until the growth finally occurs. Another risk is if developers mount successful legal challenges to the amount of development contributions payable (the North Shore outcome will be an important legal precedent).

By geographic area Auckland stands out as the major driver to high rates increases with a forecast increase of 91%, while every region south of Auckland on average is expecting rates increases less than the national average of 64%. Taking into account household growth the Auckland and Bay of Plenty rate impacts in particular are reduced, although Auckland still tops the regional areas.

Funding Project

There are a number of issues with the Funding Project, including a fairly narrowly focused analysis, but this does not alter the overall conclusions. Using rateable properties in addition to households would have provided a sounder analysis covering issues with businesses and holiday homes. This data is hard to obtain but will hopefully be available to the Inquiry in the next few weeks. The Funding Project does not analyse the impact of rates by the type of ratepayer (business, rural and residential). While this would be ideal at present the data cannot easily be obtained.

The further analysis contained in this report generally confirms the main conclusions of the Funding Project:

- There is not a systemic problem
- Rates increases are being driven by investment in infrastructure and the costs of maintaining existing infrastructure
- Local Authorities are taking on significantly more debt but as a sector this is not a concern
- Rates are expected to increase significantly over the level of inflation, but by only a moderate level after accounting for growth

There is considerable diversity across the sector and a simple one fix for all approach would be dangerous.

Many communities are in the process of building better water and wastewater systems and new community infrastructure such as aquatic centres. In many of these communities rates are forecast to rise significantly. In these communities the problem of higher rates is at least partly self inflicted – higher levels of service could be deferred for a number of years. The Funding Project could have made more of an issue on this point.

Given the very large increases in rates forecast for the Auckland regional area the ‘rates issue’ may in fact largely be an Auckland issue rather than a New Zealand one.

The LTCCP forecasts provide a reasonable feel for how a council is planning for infrastructure over time. Nothing is more certain than that additional projects and activities will arise over time, costs will change and some projects will be dropped. The drivers work being carried out by GHD will provide more of a feel for the accuracy and risks of these LTCCPs. My assessment is that, given the current legislation, the risks to these rates forecasts are on the upside.

Data Availability

This project has highlighted the difficulty in obtaining the necessary information from within the local authority sector to carry out comprehensive comparative and time series research. This is despite access to datasets held by the Department of Internal Affairs (DIA), extensive contacts within the sector and years of experience in this field. The chances of many members of the public being able to make an informed assessment of their council's comparative performance during a consultation process for a Long Term Council Community Plan (LTCCP) must be close to zero.

The DIA has a website containing good data for all local authorities but it is not timely. That is, the information will be out of date for any given draft LTCCP as the data is from the previous LTCCP (or even older). Currently the general financial data available on the DIA website is from the year ending June 2005, with rates information from the 2005/06 year. For the purposes of this report the resource put into that website was of no use at all.

There is a clear need for all local authorities to produce a simple one page summary of standard key information so that the public can make a meaningful input into the LTCCP process without being a trained forensic accountant. This would include (amongst other ratios) information on impacts from rates on:

- rural, businesses and residential properties
- levels of fixed charges
- total debt and net debt
- bands of residential properties (say quartiles of valuation)
- rateable properties by rural, businesses and residential
- capital contributions
- other income

This information should be readily available to each council as part of their budgeting process for a new LTCCP.

Data Accuracy

Forecasts of expenditure and revenue, particularly other (non-rate) income, show signs of a lack of detail as the forecasts go past year seven. Capital expenditure is concentrated in the early years and given past performance across the sector these forecasts will not be achieved. The result is likely to be a flattening out of the capital expenditure line and the transfer of some of the rates increases from years two and three to further into the medium term.

Background

The Local Government Rates Inquiry is focused on the impact of rates on communities, organisations and individuals. Rates however are an end product of an individual local authority carrying out a budgetary process that first decides on how much expenditure is required for a given level of service that has been consulted on with their community. A number of revenue sources are available to fund these services, the nature of which often results in an iterative process regarding the level of service that is affordable. The final rates requirement is the funding needed, after all other sources have been considered (including borrowing), and to deliver the services agreed on.

Because of this complex process the Inquiry is interested in the trends in local authority expenditure and other revenue sources. Both the recent historical trends that drive today's rates levels, and the expected future trends from the local authority LTCCPs, help to paint a picture of the reasons behind expected rating levels.

Trends in the level of Local Government Funding and Expenditure

Operating Expenditure¹

Total Operating Expenditure

Taking into account inflation (consumers price index) over the period June 1994 to June 2006 total operational expenditure has increased by 42% in real terms. This calculation of real increases is the same using both the Consumer Price Index (all sectors), or the Producer Price Index (Inputs - local government and civil defence series). Total operating expenditure has increased significantly over the last five years in particular (2001 to 2006), rising by 45% in nominal terms. This is being driven by rising costs across all categories of expenditure with costs of providing infrastructure in particular increasing significantly.

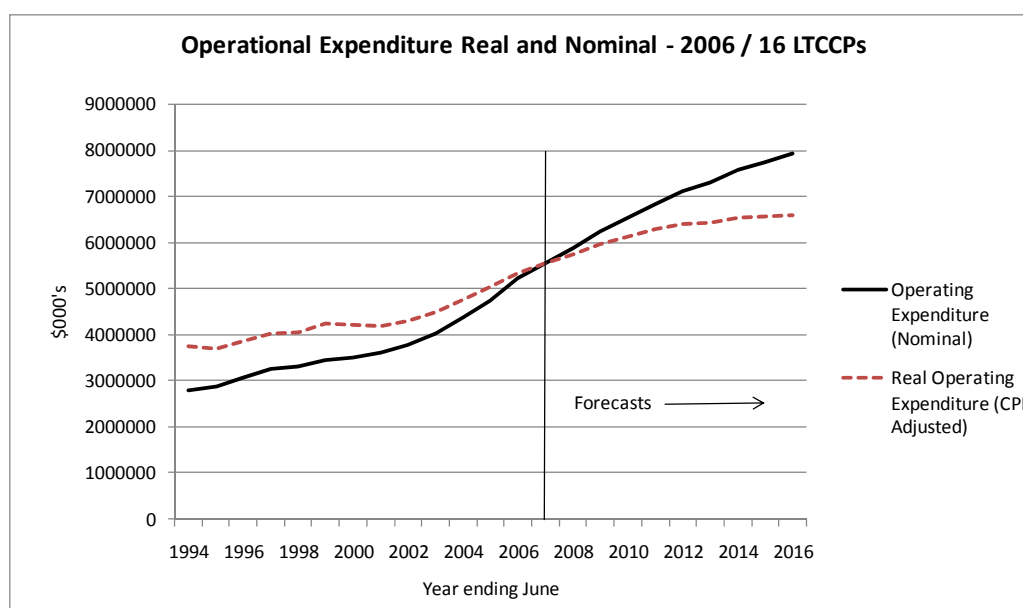


Chart 1 – Operating expenditure 2006 to 2016. Source: LTCCPs, Statistics NZ

¹ Source Statistics NZ Local Authority Statistics to 2006, Local Government Rates Inquiry forecasts and RBNZ historical CPI series

Total operating expenditure is forecast to increase by 43% from 2006/07 to 2015/16. After forecast increases of around 6% a year in the next few years the rate of increase levels off towards the end of the forecast to around 2.5% a year. This is higher than the forecast CPI increases from 2006/07 to 2015/16 of around 20%² by a considerable margin.

Local government expenditure is driven largely by the need for increased infrastructure in response to economic and population expansion.

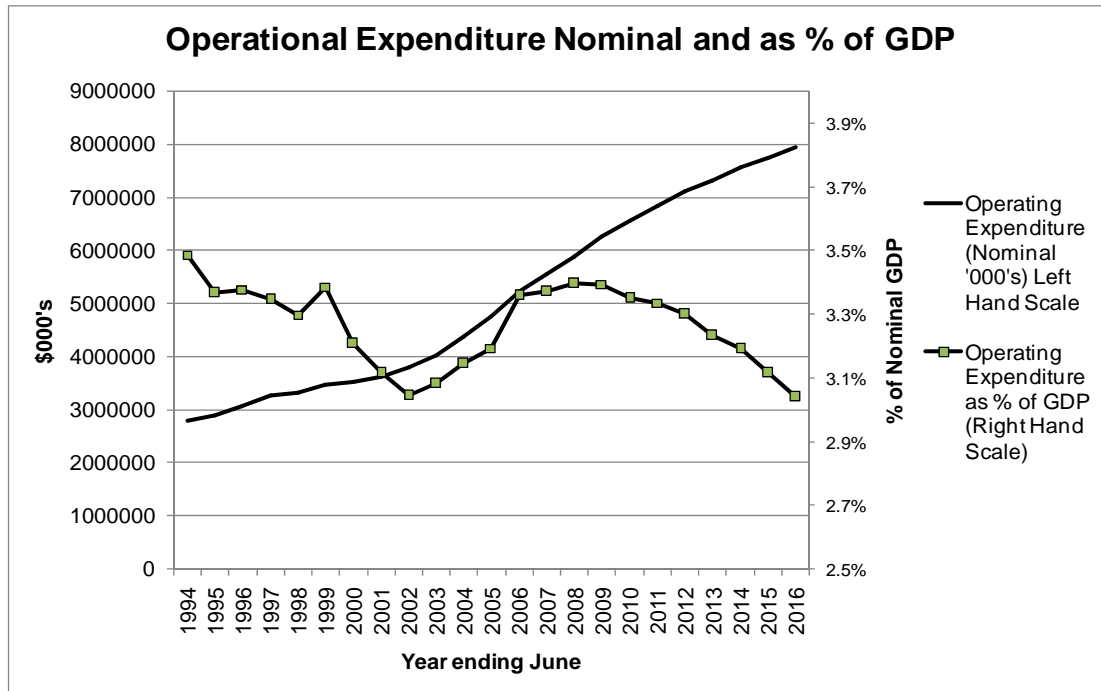


Chart 2 – Operating expenditure 1994 to 2016 and as % of GDP. Source: LTCCPs, Statistics NZ, Treasury and BERL

Operational Expenditure per Rateable Property

The increase in total operational expenditure also reflects a growing New Zealand economy and the need for local government to provide services to an expected increasing population. One measure of the actual impact of increased expenditure is to use the number of rateable properties. Forecast operational expenditure adjusted for CPI and the number of rateable properties shows that total expenditure is expected to increase by just 8% from 2006/07 to 2011/12 before easing slightly out to 2015/16. The total real increase per rateable property from 2006/07 to 2015/16 is just 7%, or under 1% per year.

² Treasury forecasts to 2011 sourced from Half Year Economic and Fiscal Update December 2006. 2% increases applied from 2011 to 2016.

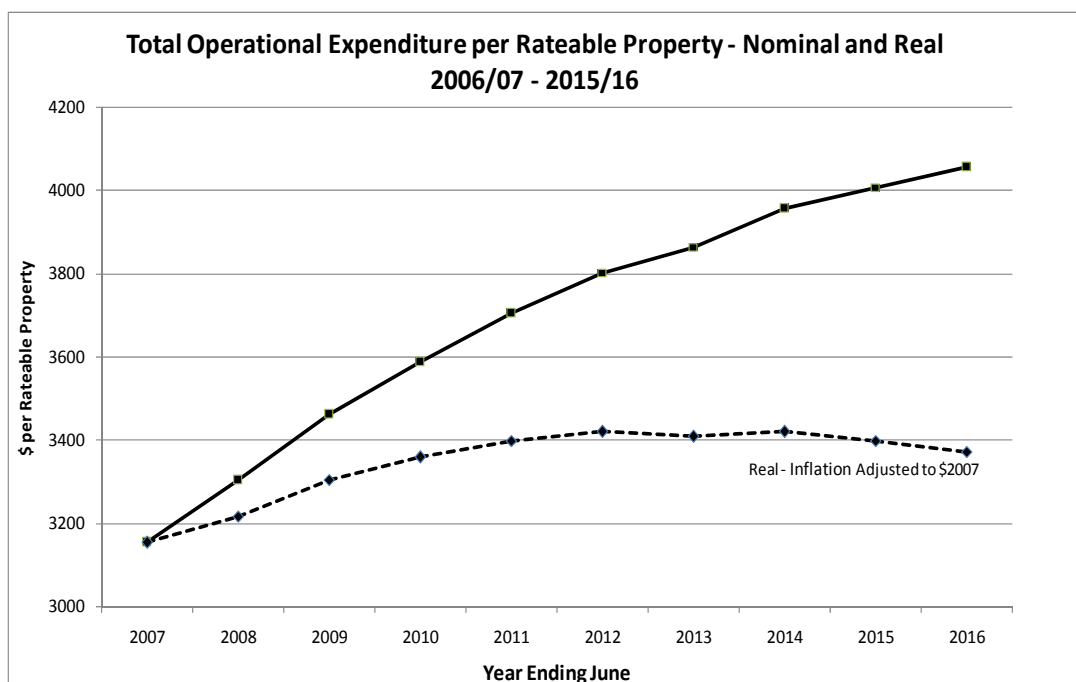


Chart 3 Total opex per rateable property 2007 to 2016. Source: 2006 – 2016 LTCCPs, Rates Inquiry

There is however considerably variation in changes in operating expenditure across the sector. Analysing total operating expenditure by type of local authority shows that generally the larger the council, the greater the increase in operational expenditure. This is consistent with the pattern of expected population growth which is concentrated in Auckland in particular.

Table 1: Opex details by council category 2007 and 2016

	Number of Councils	Total Opex 2006/07 \$ million	Total Opex 2015/16 \$ million	% change 2007 to 2016	% of Total Sector Opex 2007	% of Total Sector Opex 2016	% of Population 2006
Rural	25	395.5	514.6	30%	7%	6%	6%
Provincial	37	1,917.2	2,676.1	40%	32%	32%	45%
Metropolitan	10	2,485.6	3,715.7	50%	42%	44%	50%
Regional	12	757.1	1020.7	35%	13%	12%	
Total Sector	84	5,950.8	8,441.8	42%			

Expenditure on Goods and Services and Employee Costs

The largest category of operational expenditure is the purchases of goods and services (this also includes grants and donations) that make up 52.9% of the total. The proportion of total operational expenditure being spent on this category has increased slightly since 1993. This implies that the majority of local authority expenditure is going into providing direct services to communities and that there is no trend of this reducing over time.

Employee costs were constant throughout the 1990's, reflecting the trend to contract out services and operational functions such as road maintenance and focusing on internal cost reductions. In many cases these employee costs have been transferred to payments for goods and services by way of contract. Employee costs started increasing from 2001, well before the enactment of the LGA 2002.

Increased staff requirements have been generated mainly by:

- the growth in housing (regulatory and inspection staff)
- increasing numbers of recreation and cultural facilities
- increased government regulations and policy requirements (including building inspections) , and
- the increase in infrastructural projects (technical engineering staff and project management).

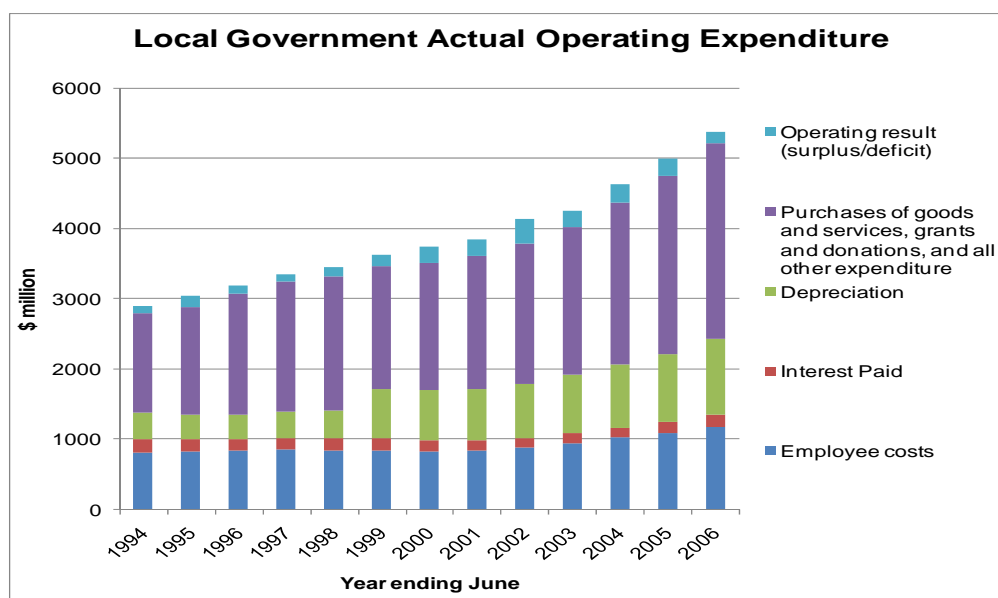


Chart 4 historical Opex. Source: Statistics New Zealand Local Authority Statistics

Employee costs made up 22.5% of total operational expenditure in the year to June 2006. This compares to 29.1% of total operational expenditure in the year to June 1994. While employee costs have been increasing over the last six years the increase has been less than that in other operational expenditure categories. The result is that the proportion of total operational expenditure being spent on employee costs is still declining.

Interest Paid, Capital Expenditure and Debt

During the 1990's many local authorities had a focus on reducing debt. This was part of a wider drive to reduce costs in general, including contracting out internal operations and reducing internal staff costs. This focus resulted from the post amalgamation bedding down of local government, government policies and legislative initiatives to restructure the economy in general and several examples in the sector of financial difficulties caused by high debt levels. These trends resulted in many local authorities aiming for low, or no, debt as a principle. This was generally supported by ratepayers.

Since 2004 these trends have changed as local authorities struggle to finance large infrastructure projects and rising costs of renewals. This trend also reflects the more relaxed attitude to debt throughout New Zealand in recent years. The 2002 LGA also focuses local authorities on community outcomes rather than financial efficiencies.

The result of all these factors is that the level of interest paid in nominal terms in the year ending June 2006 is actually lower than that paid in the year ending June 1994. As a proportion of total operating expenditure interest paid has dropped from 6.9% in 1994 to

3.4% in 2006, with a low point of 3.2% in 2004. Interest paid is now rapidly increasing as the sector takes on more debt to fund the current infrastructure spurt.

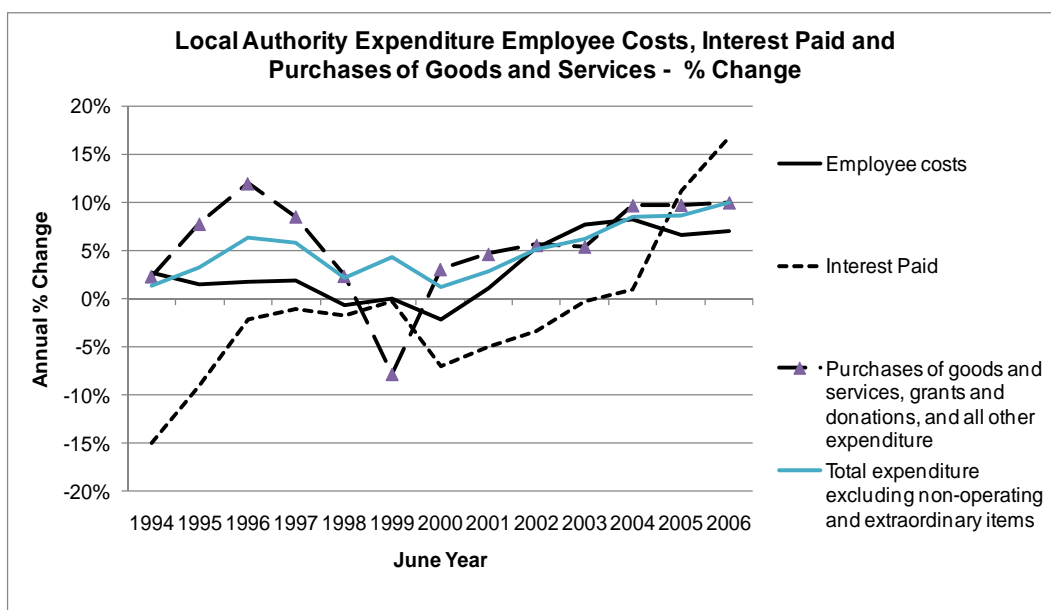


Chart 5 Historical opex by category. Source: Statistics New Zealand Local Authority Statistics

Capital Expenditure

Capital expenditure³ in the current year is at a very high level. Capital expenditure is forecast to decline significantly from this high level over the 10 year period to 2016. Total capital expenditure over the forecast period is \$30.8 billion with 55% of this (\$16.9 billion) forecast to take place in the first five year period.

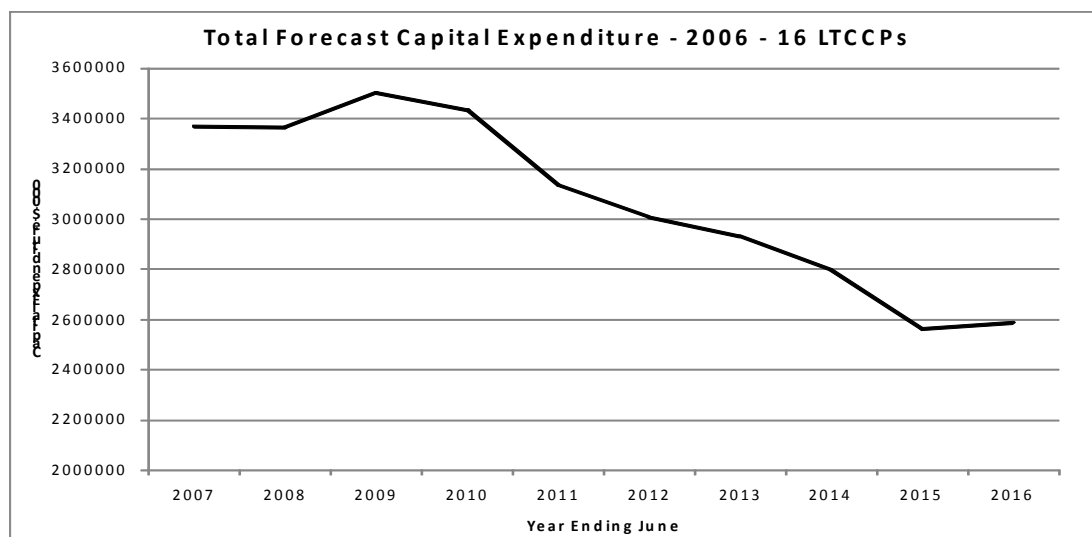


Chart 6 Forecast capex 2007 to 2016. Source: Local Authority Funding Project

A breakdown of the total forecast capital expenditure⁴ shows that the largest component is Transport which makes up 44% of all forecast capital expenditure in the 10 year period to 2016. The three waters (Water, Sewerage and Stormwater) make up 29% of forecast capital

³ Source Funding Project phase 2 Report LTCCP data

⁴ Source Funding Project phase 2 LTCCP data, with additional analysis by the Rates Inquiry

expenditure. Community Services accounts for 18% with Other (such as Economic Development, Harbours) at 9% over the 10 years.

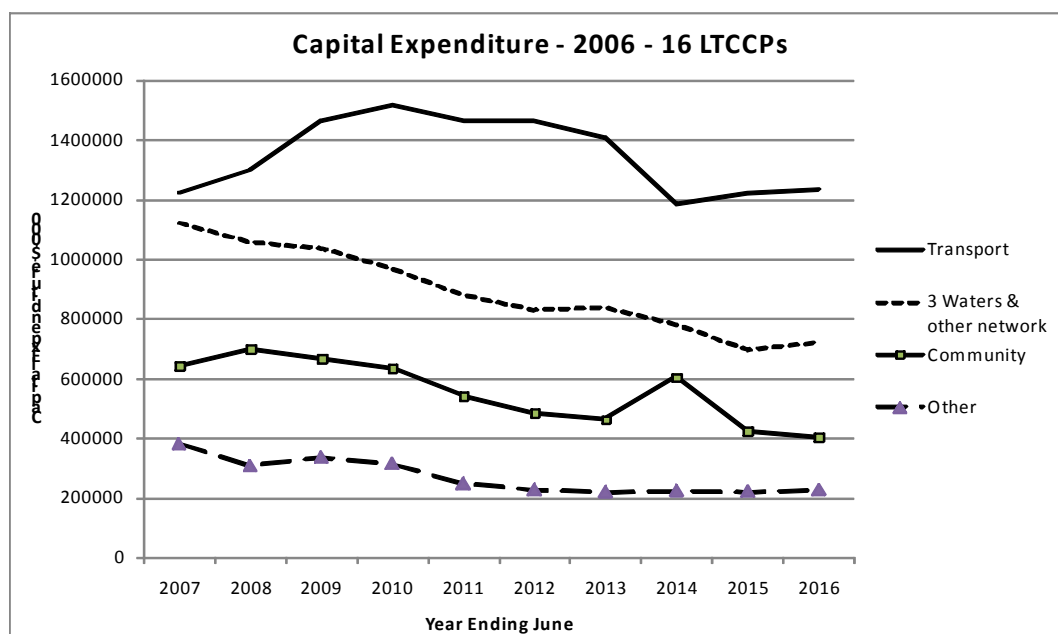


Chart 7 Capex 2007 to 2016 by category. Source: Local Authority Funding Project, 2006 – 16 LTCCPs

Table 2 Capex by category 2007 and 2016 and 10 year total

Capital Expenditure Category	2006/07 \$ million	2015/16 \$ million	Total over 10 Years 2006/07 to 2015/16 \$ million
Transport	1,223,897	1,236,007	13,486,731
Three Waters	1,120,172	719,856	8,920,860
Community	642,259	403,284	5,566,254
Other	380,539	226,204	2,703,241
Total Capital Expenditure	3,390,197	2,597,127	30,788,019

Source: Local Authority Funding Project, 2006 – 16 LTCCPs

Note : several councils capex forecasts were unable to be sourced so categories do not tally to total figure.

The table above shows that the Transport category is the only one where the nominal level of capital expenditure is at the same level in 2015/16 as it is in 2006/07. The other categories are significantly lower in nominal dollars. One reason for this is the extensive work that is required to be made on 10 year road transport forecasts as part of the Regional Land Transport Strategies. This level of resource has yet to be made on forecasts of other capital expenditures. The possibility exists then that these capital expenditure forecasts understate the likely amount of capital expenditure in the last three or so years of the 10 year forecast.

Total Debt⁵

The trend of increasing debt levels evident from the rising levels of interest paid in the operating expenditure budgets over the last few years is forecast to continue to 2013/14 after

⁵ Source Funding Project phase 2 Report data – excludes accounts payable and term liabilities that are not borrowing.

which total debt starts to decline. Total debt is expected to increase from \$4 billion in 2006/07 to \$8.2 billion in 2015/16. While this is a large increase, total assets are \$116 billion in 2015/16 giving a debt to asset ratio of 7%. The Funding Project Phase 2 Report covers this area well.

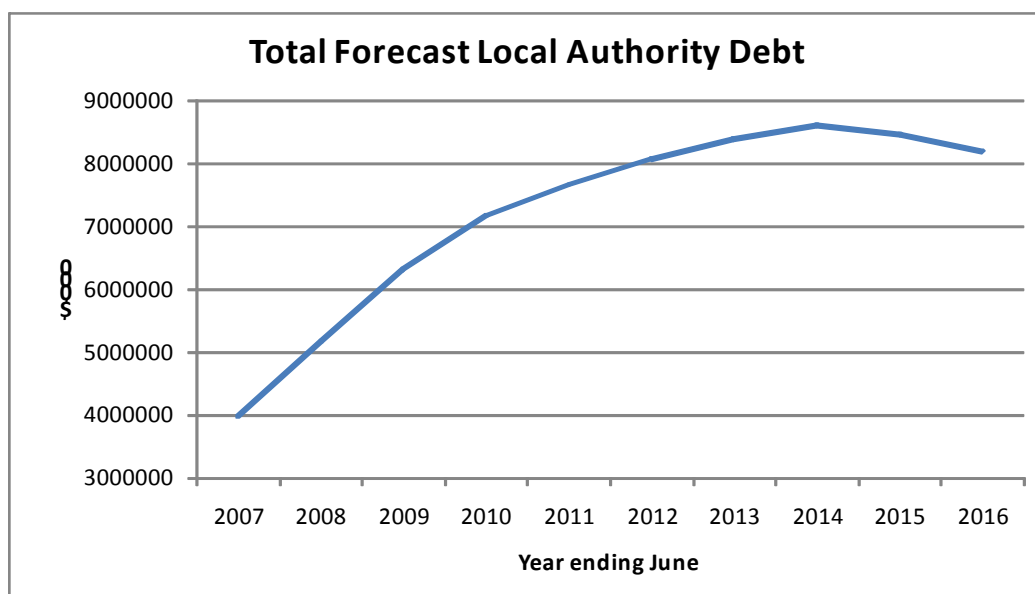


Chart 8 Forecast Debt 2007 to 2016. Source: Local Authority Funding Project

Debt levels are not spread evenly across the different sizes of councils. Using the Local Government New Zealand definitions of rural (less than 20,000 usually resident population), provincial (between 20,000 and 90,000 usually resident population), metropolitan (above 90,000 usually resident population) and regional councils (unitary councils have been included in the TLA sectors for this analysis) gives an indication as to where increasing investment in infrastructure is being funded by debt.

Table 3 Debt by category 2007 and 2016 and 10 year total

	Number of Councils	Total Debt 2006/07 \$ million	Total debt 2015/16 \$ million	% change 2007 to 2016	% of Total Sector Debt 2007	% of Total Sector Debt 2016	% of Population 2006
Rural	25	187.4	317.0	69%	5%	4%	6%
Provincial	37	1,864.7	2,895.5	55%	47%	35%	45%
Metropolitan	10	1,752.6	4,692.0	168%	44%	57%	50%
Regional	12	165.6	306.5	85%	4%	4%	
Total Sector	84	3,970.3	8,211.0	107%			

Source: Local Authority Funding Project and Statistics New Zealand 2006 Census

The table above shows that the 10 metropolitan councils are driving the large increase in forecast debt and account for 68% of the total sector increase by 2015/16. The other sectors show a declining share of total sector debt over the 10 years. Comparing proportions of sector debt indicates that the metropolitans are currently light on debt relative to population share.

Interest Costs

Interest costs⁶ for the sector increase significantly from \$232 million in 2006/07 to \$600 million in 2015/16, an increase of 159%. Interest costs level out in 2013/14 reflecting the trend in total debt and the decline in capital expenditure.

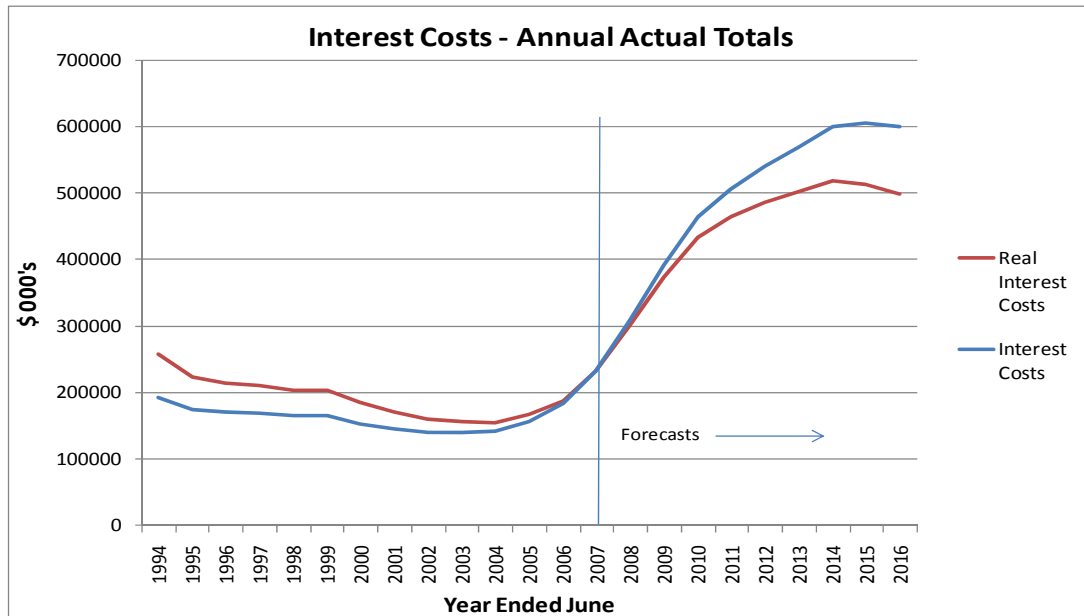


Chart 9 Interest costs 1994 to 2016 real and nominal. Source: Local Authority Funding Project. Statistics New Zealand CPI and BERL Forecasts

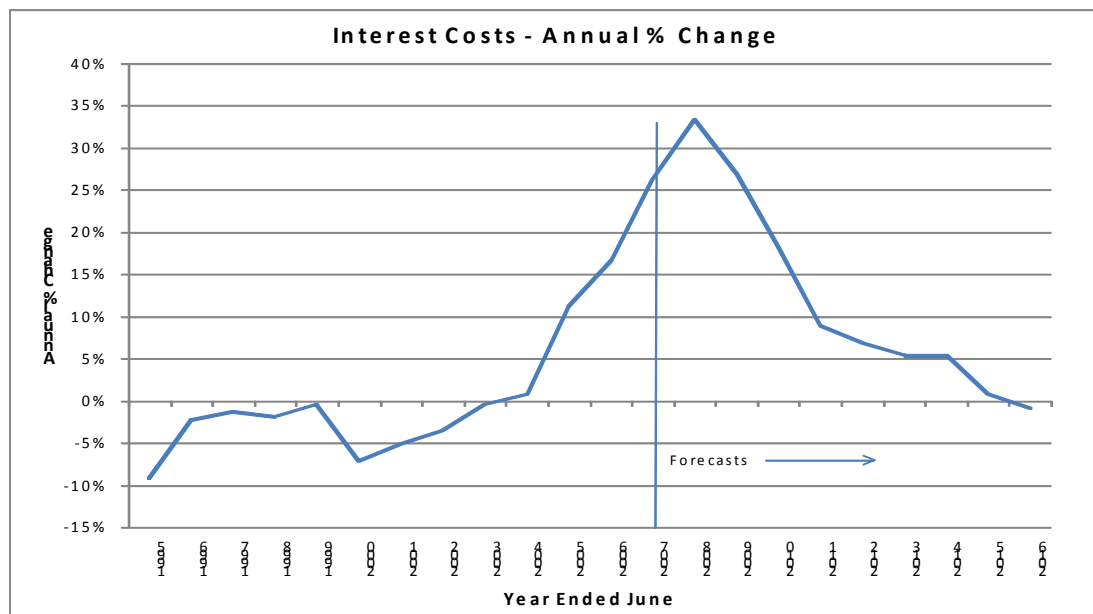


Chart 10 Interest costs 1994 to 2016 % change. Source: Local Authority Funding Project

The interest costs to rates income ratio is an important measure of financial health for local authorities. As covered in the Funding Project it is considered that a ratio of 20% is the prudent limit. As a sector this ratio is well under control reaching a ratio of just under 12% in 2012/13. The ratio is declining at the end of the forecast period.

⁶ Source Statistics NZ Local Authority data and Rates Inquiry from LTCCPs

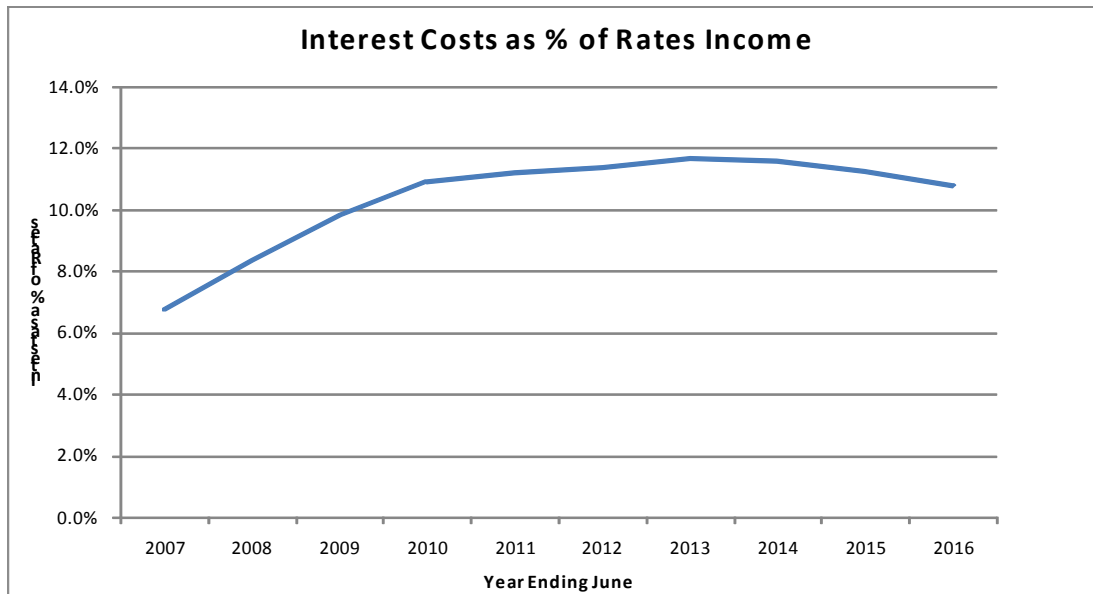


Chart 11 Forecast interest costs as % of Total Rates 2007 to 2016. Source: Local Authority Funding Project

The interest cost to rates ratio sector average conceals a wide range of situations at the individual local authority level. At one end of the spectrum there are nine local authorities with no debt costs at all, rising to 10 by 2015/16. All of the TLA's with no debt are smaller rural councils or regional councils. At the other end of the spectrum are seven territorial councils that are forecasting to be well above what is considered to be a prudent ratio of interest costs to rates (20%). These seven include high growth, two metropolitan, a small growth provincial and small declining rural councils – there is no clear pattern although three are high growth.

Clearly the large majority of local authorities are forecast to be in a sound financial position in 2015/16 and the sector as a whole can take on more debt. However there are almost a quarter of councils where taking on significantly more debt is not advisable, and around 8% who expect to have significant issues on debt levels in 10 years time. A cautionary note is that the debt data is total debt, not net debt. At least a few of the councils with the highest forecast interest cost to rates ratios have significant cash investments that for political reasons have not been utilised (usually the proceeds of a sale of electricity or other assets).

Table 4 Interest costs as % of rates 2007 and 2016 by band, regional and TA

Interest Costs as % of Rates	2006/07 Year Ending June		2015/16 Year Ending June	
	TLA	Regional	TLA	Regional
0%	5	4	6	4
1 – 8%	43	7	33	6
9 – 12%	13	1	13	2
13 – 19%	10	-	13	-
20% plus	1	-	7	-
Average %	7.4%	2.0%	11.7%	3.4%

Source: Local Authority Funding Project

Depreciation

Over recent years the timing of changes to the level of expenditure appears to be driven largely by legislative changes. The introduction of the Long Term Financial Strategy requirements into the LGA 1974 in 1996 led to a large reassessment of depreciation requirements by 1998/99. Since 2000 depreciation expenses have steadily increased with significant increases over 2006 as the 2006 / 16 LTCCPs impacted.

Since the year ending June 1994 depreciation expenses have tripled in nominal terms. Depreciation expenses as a proportion of total operational expenditure has increased from 13% in the year ending June 1994 to 21% in the year ending June 2006. As such depreciation expenses have been a major driver of the overall increase in total operational expenditure. Of interest though is the fact that over the last five years depreciation expenses as a proportion of total operational expenditure has remained basically at the same level.

Depreciation⁷ is forecast to be a major driver of total operating expenditure over the next 10 years with a 61% increase in depreciation expenditure over that time. Depreciation increases its proportion of total operational expenditure to over 22% by 2016. As depreciation is funded by rates this is a major driver of forecast rates increases. The large increases in depreciation evident from 2004 gradually reduce over the forecast period to around 3% a year. This trend reflects the capital expenditure programme which is also forecast to reduce over the forecast period. The depreciation forecasts are also impacted by forecast revaluations of assets.

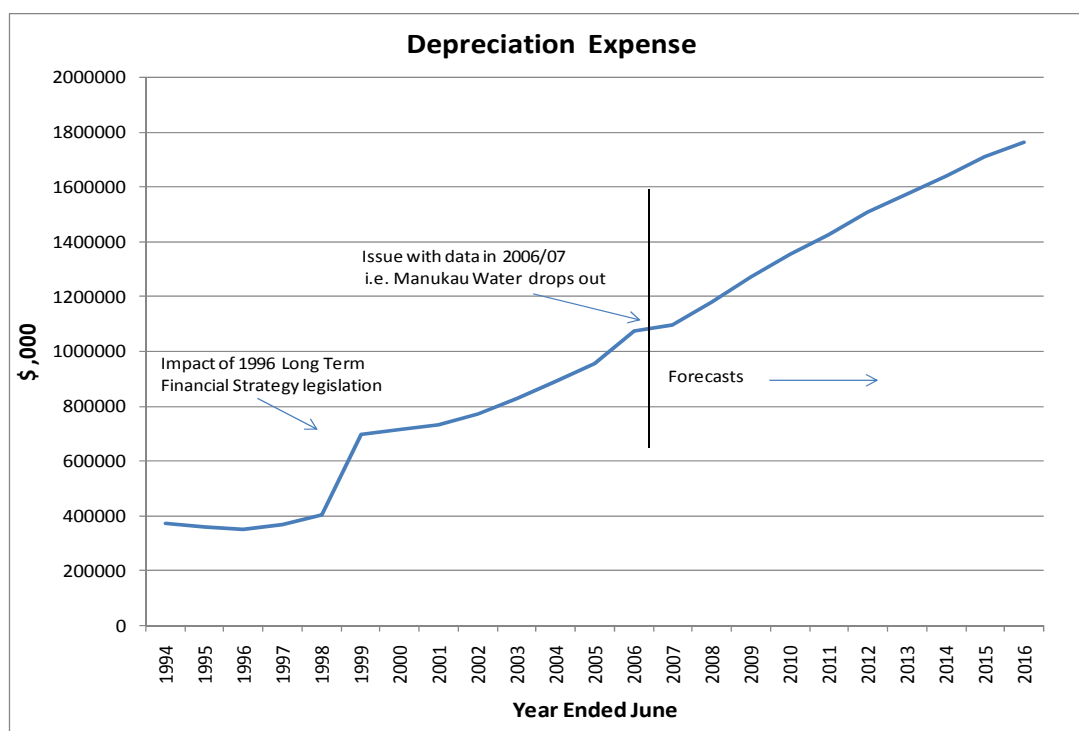


Chart 12 Depreciation expense 1994 to 2016. Source: 2006 – 16 LTCCPs, Statistics New Zealand Local Authority Statistics

⁷ Data to 2006 from Statistics NZ Local Authority Statistics. 2007 onwards from LTCCPs compiled by Rates Inquiry

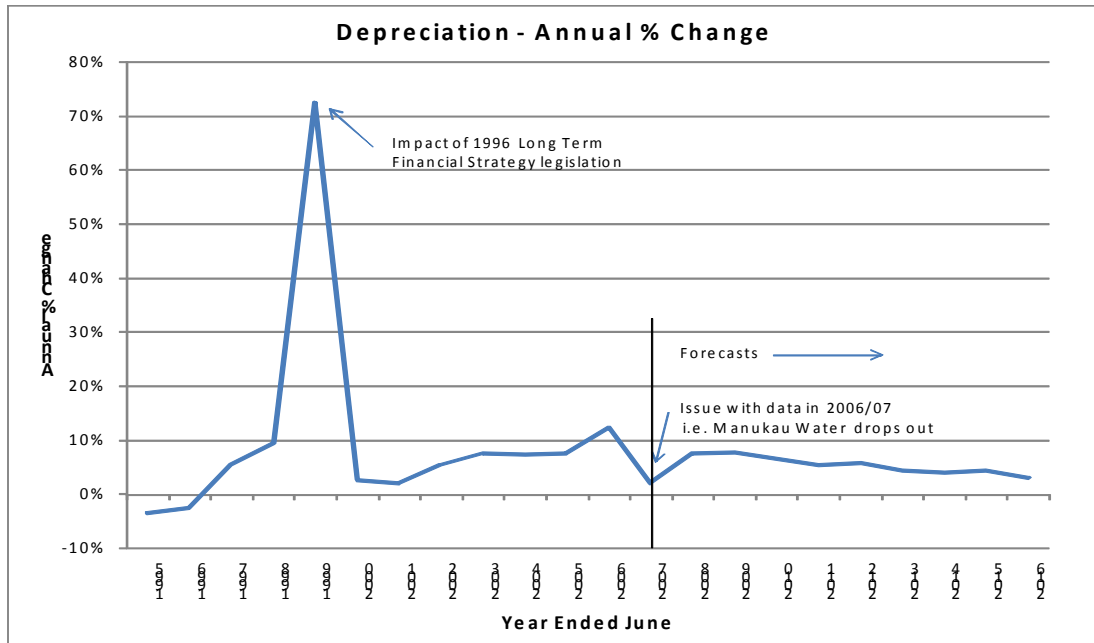


Chart 13 Depreciation expense 1994 to 2016 % change. Source: 2006 – 16 LTCCPs, Statistics NZ Local Authority Statistics

By size of council (population) depreciation impacts are forecast to be impacting on larger councils to a greater extent. This does, to some extent, reflect the large capital spending programme being forecast by metropolitan councils. The figures also give rise to the question – have the smaller councils properly budgeted in the ‘right’ level of depreciation costs? Or did they have better budgeting of depreciation to begin with?

Table 5 Depreciation by council category_2007 and 2016

	Number of Councils	Total Depreciation 2006/07 \$ million	Total Depreciation 2015/16 \$ million	% change 2007 to 2016	% of Total Sector Depreciation 2007	% of Total Sector Depreciation 2016	% of Population 2006
Rural	25	112.8	153.8	36%	10%	9%	6%
Provincial	37	442.0	692.7	57%	40%	39%	45%
Metropolitan	10	507.8	865.3	70%	46%	49%	50%
Regional	12	34.9	51.5	47%	3%	3%	
Total Sector	84	1,097.5	1,763.3	47%			

Source: 2006 – 16 LTCCPs, Statistics New Zealand 2006 Census

Operating Revenue

Total Operating Revenue and Total Rates

Local authority total operational revenue⁸ has increased over the period June 1994 to June 2006 by 85% in nominal figures. Total operating revenue has increased by 41% in real terms over the same period. The rate of increase has gathered pace over the past five years in particular with nominal total operational revenue 40% higher in the year ending June 2006 compared to the year ending June 2001. The level of increases in rates income has tracked these changes at a slightly lower level, growing by 37% over the same five year period. Rates increased in real terms by 38% from June 1994 to June 2006. Rates made up 56% of total operating revenue in the year ending June 2006, compared with 57% in the year ending June 1994. This comparison indicates that local authorities have not been increasingly reliant on rates funding alone to fund their operations in recent times. Conversely it also indicates that the sector on average has been unsuccessful in reducing the reliance for the majority of its income from rates.

Note that the inflation adjusted series use the Consumer Price Index (CPI) as the deflator. Actual cost increases faced by local government over the last five years in particular has been higher than the CPI. While this is acknowledged the CPI is generally the index used by local authority rates customers as the benchmark, especially beneficiaries.

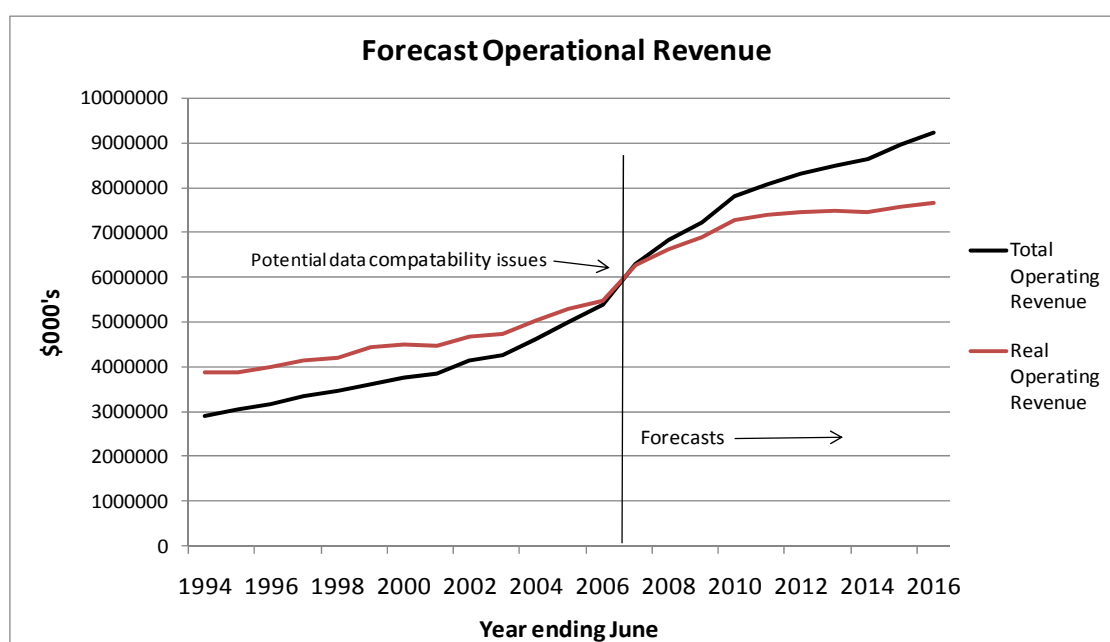


Chart 14 Operational revenue 1994 to 2016. Source: Statistics New Zealand Local Authority Statistics, CPI, BERL forecasts, 2006 – 2016 LTCCPs

Another note of caution should be made when comparing this data over time. Charges from Council Controlled Organisations are not included in this Rates series, nor are water charges by meter. Over time a number of councils have moved water services and other businesses (such as solid waste) from core council operations to Council Controlled Organisations or external contracts. This will have shifted costs from rates to charges. Over the sector this may not have had a significant impact on the series trends, but the actual impact has not been

⁸ Source Statistics NZ Local Authority Statistics

quantified. In a small number of councils this has had a major impact in shifting the incidence of costs. Total operating revenue is forecast to climb 47% between 2006/07 and 2015/16. This is higher than the expected increase in operating expenditure and results in a substantial sector operating surplus of \$1.3 billion in 2015/16. This large surplus is utilised for capital expenditure, the building of reserve funds to replace assets in the future (depreciation) and/or the repayment of debt.

Taking into account forecast inflation (CPI) over the period June 2007 to June 2016 total revenue is forecast to increase by 22% in real terms, while rates are forecast to increase in real terms by 37% over the same period.

Historical Components of Operating Revenue

Rates continue to provide the majority of operating revenue for local authorities, as it traditionally has done, by a considerable margin. This is followed in the year ending in December 2006 by the sale of goods and services, government grants and subsidies, regulatory income and petrol tax and investment income in that order.

Table 6 Operating revenue by category 1994 and 2006

Operating Revenue	% of Total Operating Revenue Year Ended June 1994	% of Total Operating Revenue Year Ended June 2006
Rates	57.3%	56.1%
Sales of goods and services and all other income	20.3%	19.7%
Government grants and subsidies	10.3%	12.7%
Regulatory income and petrol tax	5.1%	5.8%
Total Investment Income	7.0%	5.7%

Source: Statistics New Zealand Local Authority Statistics

The proportion of funding from central government has risen strongly since 2002. This series is largely road funding under the Financial Assistance Rate formula for local roads. As the price of maintaining and building the roading network has increased significantly recently, so to has the value of the central government contribution. In addition there have been a number of funds established to provide national subsidies to increase the quality of infrastructure in those areas with the greatest need. While these central government funds have increased by 70% in the last five years to June 2006, these still only make up 12.7% of total operating revenue, up from 10.3% in the year to June 1994.

Regulatory income and petrol tax has increased faster than total operating revenue since 1994. This reflects the implementation of the Resource Management Act and the passing on of costs of a more complex council regulatory system.

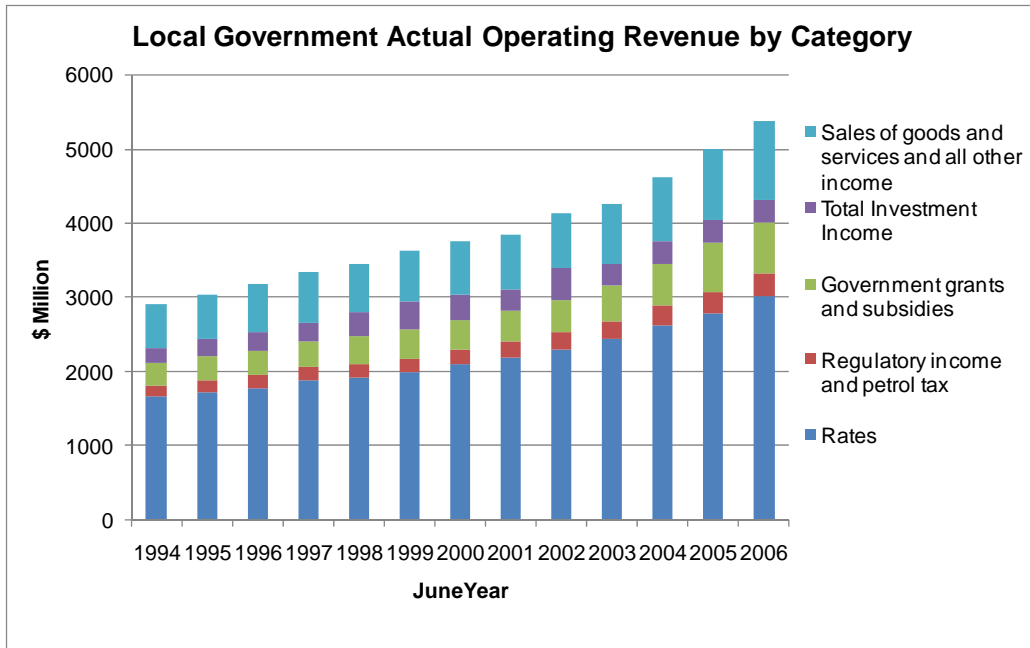


Chart 15 Operating revenue by category 1994 to 2006. Source: Statistics NZ Local Authority Statistics

Sales of goods and services and all other income and investment income have both reduced their share of total operational revenue since 1994. Investment income has declined due to a number of local authorities selling all or parts of business assets during the last 10 years. These business assets were generally ports, airports and electricity assets allocated to councils as part of the 1989 amalgamation processes.

Sales of goods and services and all other income have generally shifted prior to large changes in the level of rates. It is common for local authorities to look to increase fees and charges first before increasing rates; hence these charges often increase prior to large increases in rates. Sales of goods and services and all other income have increased rapidly in the last five years increasing 52%, much faster than previously. This category includes water sold by meter charges.

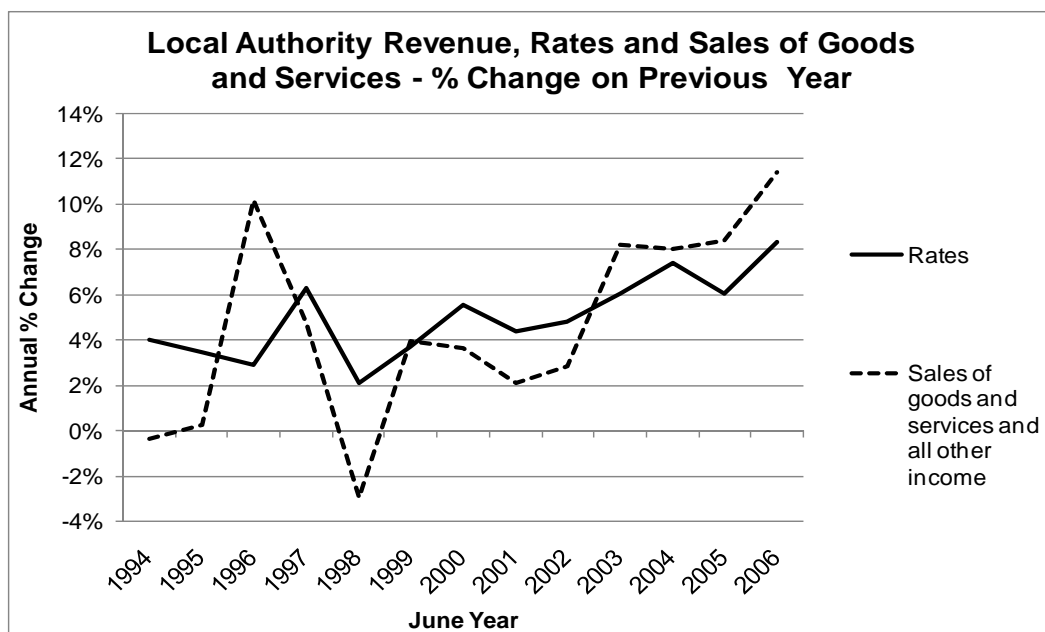


Chart 16 Rates and sales income % change. Source: Statistics New Zealand Local Authority Statistics

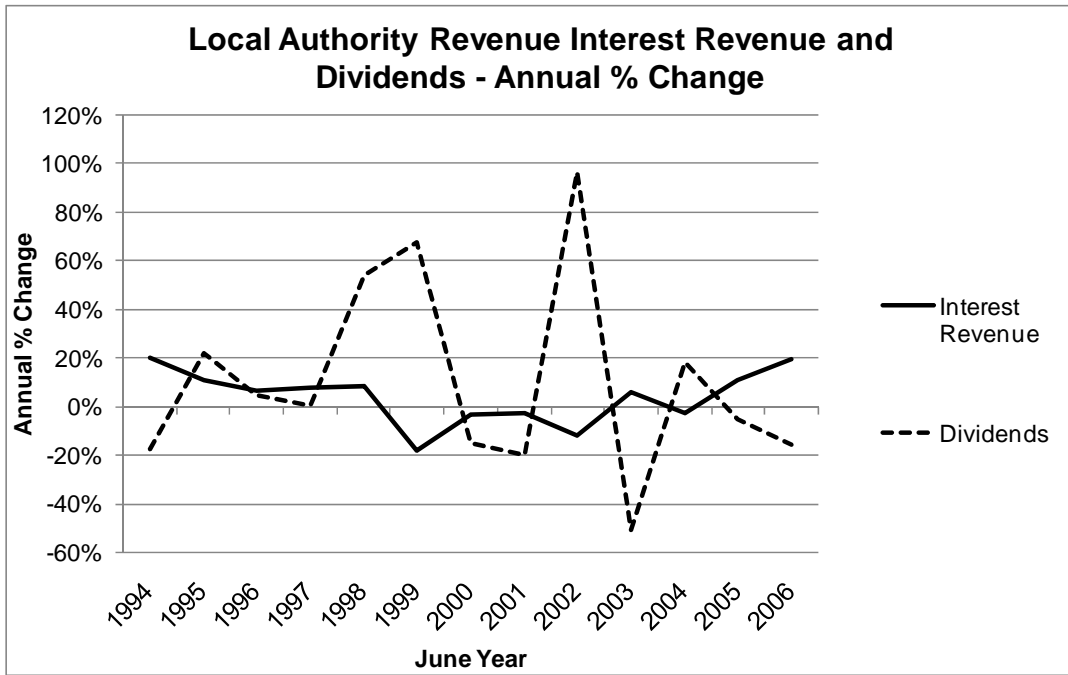


Chart 17 Interest and dividend revenue 1994 to 2006 % change. Source: Statistics New Zealand Local Authority Statistics

The large increase in government grants over 2004 and 2006 also reflect government assistance in response to large natural events as well as roading and other infrastructure subsidies. These included responses, for example, to flooding in the lower north island in 2004 and snowfalls in the south island in 2006.

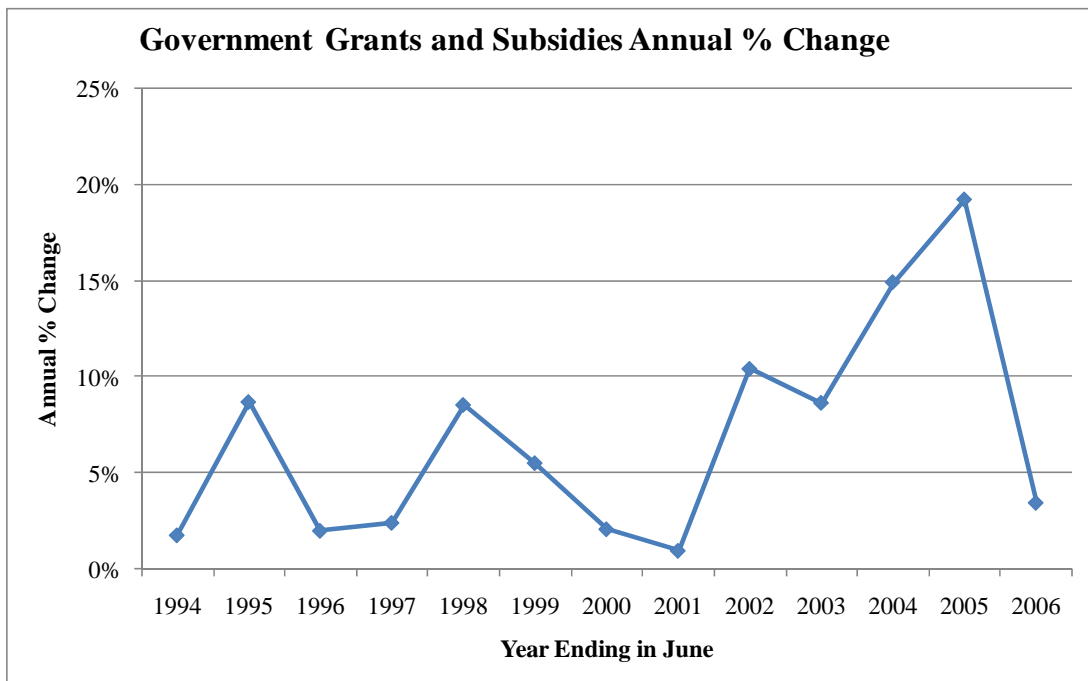


Chart 18 Government grants % change 1996 to 2006. Source: Statistics New Zealand Local Authority Statistics

Rates and Rating Measures

The forecast level of rates⁹ follows the operating expenditure trend but with a higher level of increases. Rates increases of around 8% a year in the next few years reduce to increases of around 4% a year. Rates are forecast to increase by 64% between 2006/07 and 2015/16. This will increase rates overall proportion of operating revenue from 54% in 2006/07 to 60% in 2015/16. This is effectively filling in the gap left by non-rate income growing at a slower rate than operating expenditure.

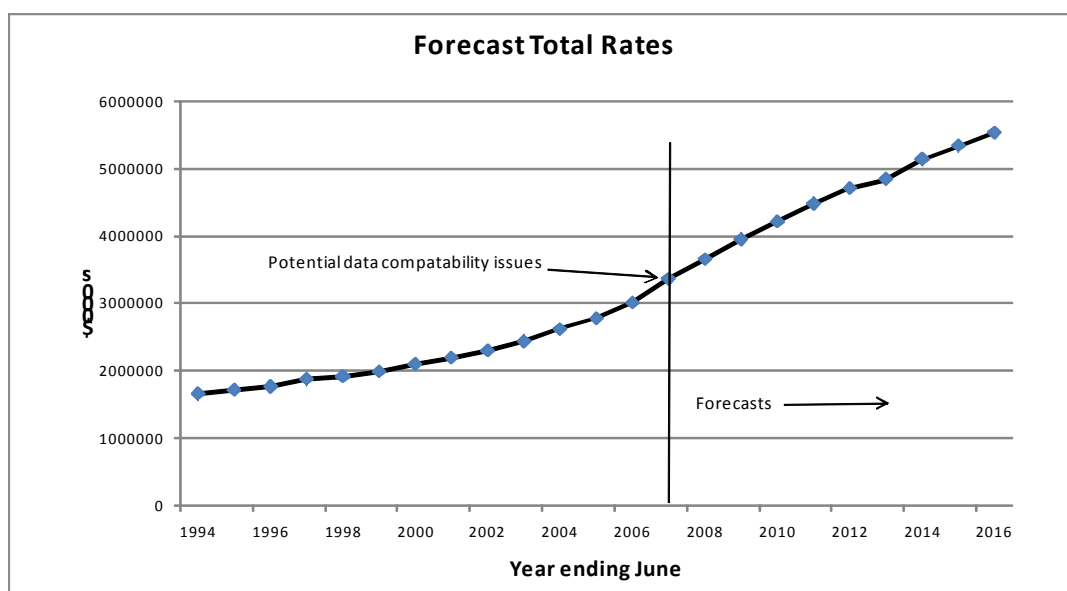


Chart 19 Total Rates 1994 to 2016. Source: Statistics New Zealand, Local Authority Funding Project

Rates as a Proportion of Gross Domestic Product

A long term measure of the level of rates is to compare them to the nominal level of total GDP¹⁰ for the country. This indicates whether rates are taking a smaller or larger share of the total output of the country in a given year. The chart below shows that local authority rates declined as a proportion of GDP over 1999 to 2002. Since then the proportion has increased to above the levels seen in the mid 90's.

The forecast rates levels can be tracked as a percentage of expected GDP¹¹ to see whether rates are taking a smaller or larger share of the total output of the country in a given year. Over the years from 1961 to today rates as a proportion of GDP have seen three major peaks. These have tended to follow periods of national expansion and / or significant inflationary pressures. From 2000 to 2005 rates were at historically low ratios of below 1.9%. Rates are forecast to climb to almost 2.2% of GDP by 2011/12 before falling back to around 2.1% by 2016. This ratio indicates that rates as a proportion of the total economy are forecast to remain within historical boundaries and are in a traditional 'catch-up' phase to cope with an expanding economy.

⁹ Source - the Funding Project phase 2 data. This rates series has excluded GST

¹⁰ Source Statistics New Zealand

¹¹ Treasury forecasts of GDP to 2011 sourced from Half Year Economic and Fiscal Update December 2006. BERL for forecasts 2011 to 2016 and historical data. Rates Inquiry for Rates forecasts.

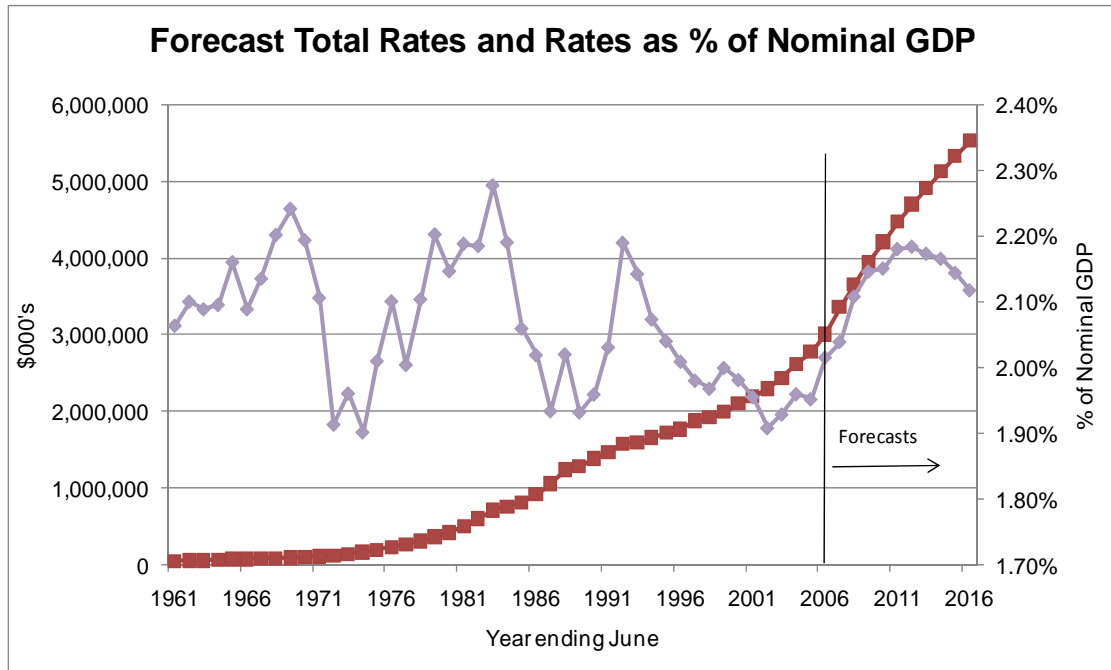


Chart 20 Total rates nominal and as % of GDP. Source: Local Authority Funding Project, BERL and Statistics New Zealand

As a percentage of GDP local government taxes (rates) are a small part of overall government taxes in New Zealand. Central government taxes as a percentage of GDP have almost doubled over the last 40 years, while rates have remained at about the same proportion (2%). The proportion of rates in total taxes therefore has fallen significantly since 1961.

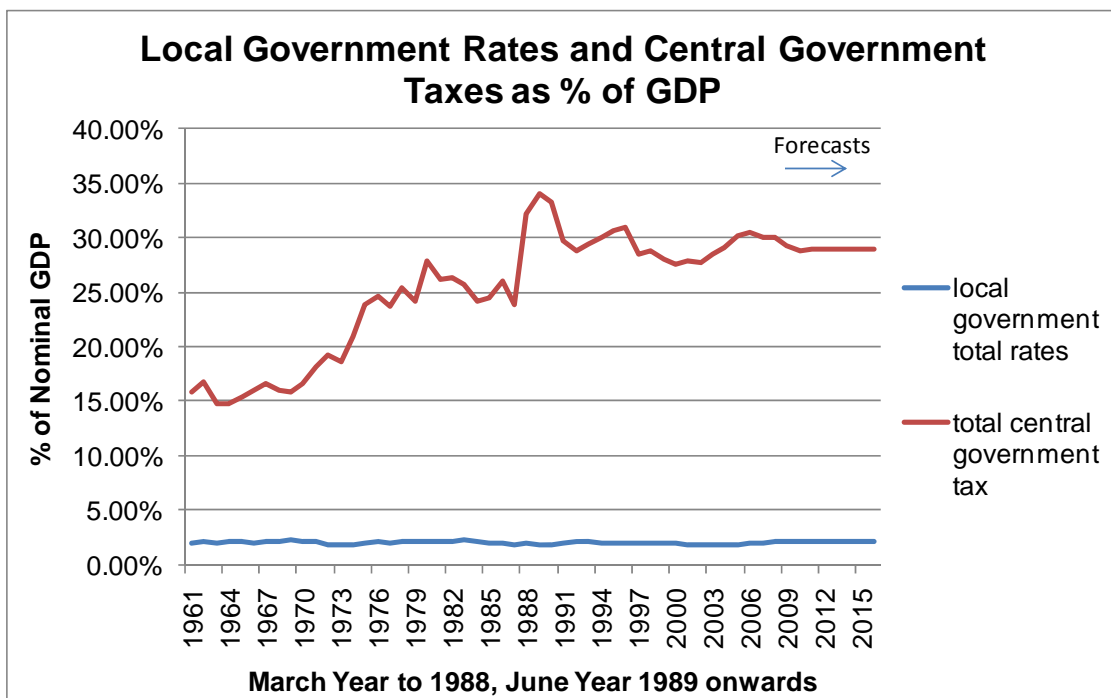


Chart 21 Rates and taxes 1961 to 2016. Source: Local Authority Funding Project, BERL and Statistics New Zealand

Rates per Rateable Property

With rates increasing at a faster proportion than operating revenue the rates per rateable property ratios and real rates per rateable property ratios are also showing greater increases than revenue and operating costs per rateable property ratios. Nominal rates per rateable property are forecast to increase by 48% from 2006/07 to 2015/16. Real rates per rateable property are forecast to increase by 23% from 2006/07 to 2015/16.

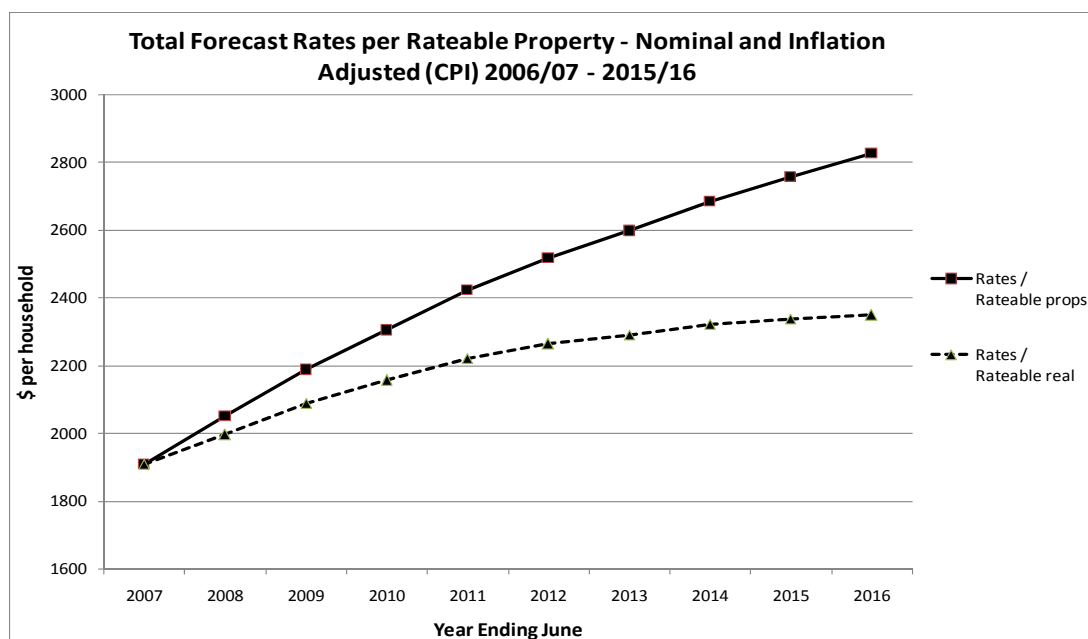


Chart 22 Rates and rates per rateable property 2007 to 2016. Source: Local Authority Funding Project, 2006 – 2016 LTCCPs and Manukau City Council

Rates by size of Council

The forecast increase in rates over the next 10 years appears to be related to the size of the council, the larger the council the greater the expected rates increase. The 10 metropolitan councils alone account for 58% of the increase in TLA rates to 2015/16. Smaller rural based councils are forecasting on average an increase in rates income of 41% over the next 10 years.

Table 7: Rates 2007 and 2016 by council category.

	Number of Councils	Total Rates 2006/07 \$ million	Total Rates 2015/16 \$ million	% change 2007 to 2016	% of Total Sector Rates 2007	% of Total Sector Rates 2016	% of Population 2006
Rural	25	243.1	342.3	41%	7%	6%	6%
Provincial	37	1,220.9	1,947.2	59%	36%	35%	45%
Metropolitan	10	1,513.9	2,641.0	74%	45%	48%	50%
Regional	12	384.5	594.5	55%	11%	11%	
Total Sector	84	3,362.4	5,525.1	64%			

Source: Local Authority Funding Project, 2006 – 2016 LTCCPs, Statistics NZ 2006 Census

Rates per Rateable Property by Size of Council

The rates by rateable property analysis showed that rates per rateable property across the whole sector were forecast to increase by 48% over the next 10 years. The table below summarises the rates impact per household by sector size in nominal values.

Of interest is that average rates per rateable property for rural councils are currently lower than for provincial and metropolitan councils. By 2015/16 the average rates per rateable property has become even more divergent by size of council. Possibly the larger councils are going through a catch up phase for past underfunding as well as providing for new infrastructure. This analysis is a simple average of the amount of rates per household so it treats each council as an equal with no weighting.

Table 8: Rates per rateable property 2007 and 2016 by council category.

Sector of LG	Number of Councils	Average rates \$ per Rateable Property 2006/07	Average rates \$ per Rateable Property 2015/16	% change 2006/07 to 2015/16
Rural	25	\$1,659	\$2,243	35%
Provincial	37	\$1,777	\$2,554	44%
Metropolitan	10	\$2,062	\$3,093	50%
Regional	12	\$258	\$359	39%
Total Sector	84	\$2,148	\$3,181	48%

Source: Local Authority Funding Project, 2006 – 2016 LTCCPs, Manukau City Council

Note: Regional council rates are added to the territorial council average total to obtain the total sector rates per household. These Figures are GST Inclusive.

There are three main reasons for the difference in average rates per rateable property between large and small councils. First, larger councils tend to provide higher levels of service for recreation and cultural facilities. Secondly large councils often provide facilities and services that smaller councils do not provide at all (and these are often used by neighbouring smaller councils). Finally large councils have a much higher proportion of business properties and often have a differential in place that results in higher than average rates being levied on this type of property. This results in the overall average rates per rateable property figure being significantly higher than it is for residential properties only.

Other non-rating Income - excluding Development Contributions

This category includes fees and charges, grants (including central government road funding) and all other funding sources not included in rates and development contributions.

Forecast other revenue is not expected to keep pace with total revenue or operating expenditure, increasing by only 22% between 2006/07 and 2015/16. Other revenue as a proportion of total operating income falls from 42% in 2006/07 to 35% in 2015/16. As a result of this rates are forecast to increase faster in order to meet the required funding. There is a question over the accuracy of the LTCCP budget forecasts with a possible lack of forecasting rigour beyond 2009/10.

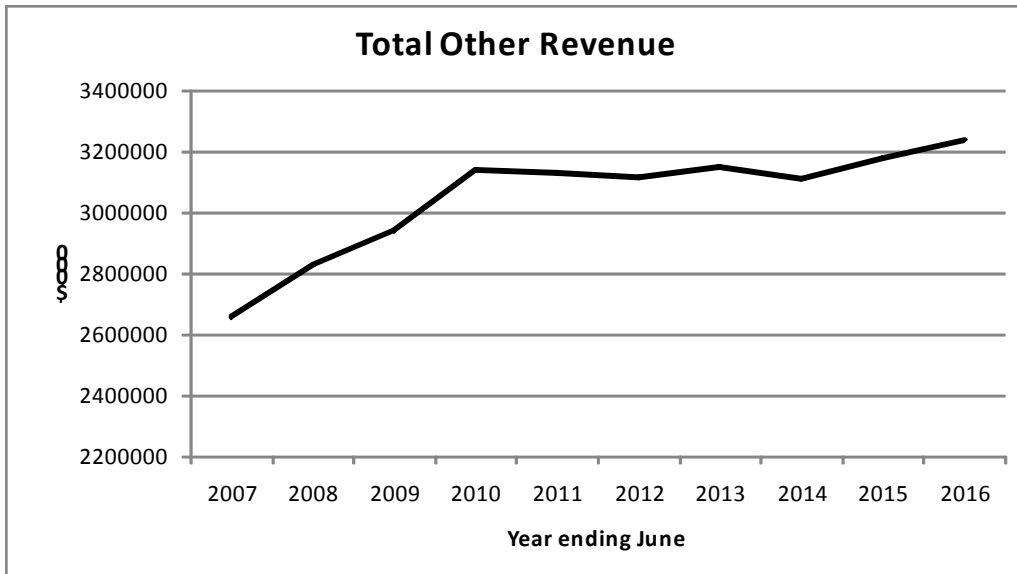


Chart 23 Other revenue 2007 to 2016. Source: Local Authority Funding Project, 2006 – 2016 LTCCPs

Development Contributions

The LGA 2002 gave a new ability for councils (excluding regional councils) to charge development contributions on property developments. These new charges allow councils to charge for the expected future capital costs to provide services for new developments based on their share of expected future growth. Councils across New Zealand, particularly those with higher growth rates, have moved to utilise these new charges. As a result of this, and the high growth rates and infrastructure costs forecast by the metropolitan councils in particular, forecast development contributions show a massive increase. The chart below should be taken as a large survey rather than a complete census of councils. Some of the data includes financial contributions while a few council's data could not be sourced at this time.

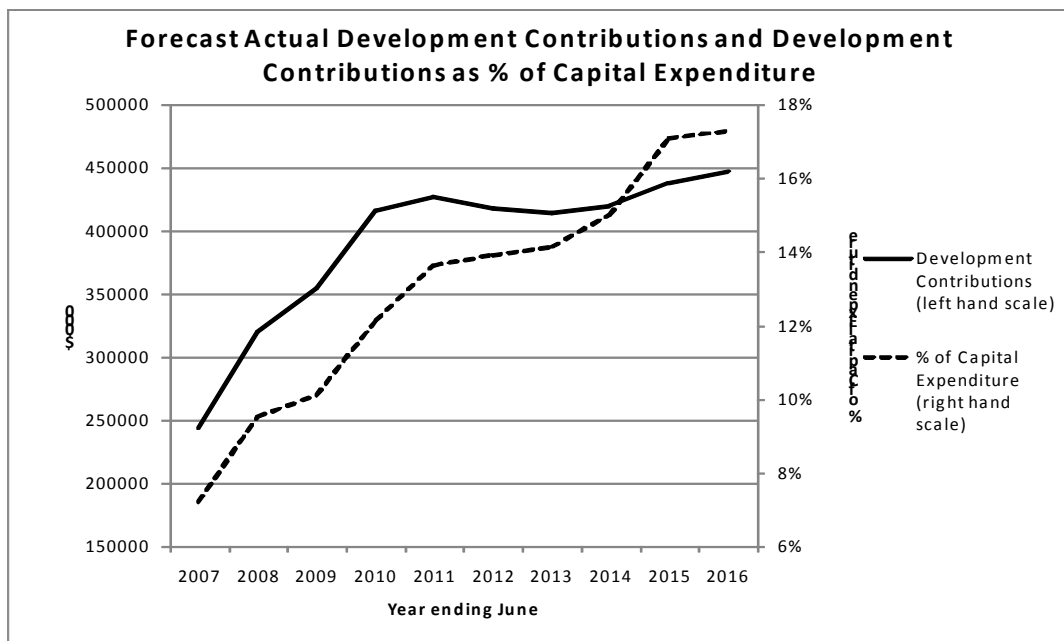


Chart 24 Development contributions nominal forecast and as % of forecast capex. Source: Local Authority Funding Project, 2006 – 2016 LTCCPs

Over the forecast period development contributions are expected to increase from \$244 million in 2006/07 to \$447 million in 2015/16. As a percentage of capital expenditure this survey shows that development contributions will increase from 7% in 2006/07 to 17% in 2015/16.

This highlights a risk that is generated by strong growth. Infrastructure has to be invested in and built before new houses are built. Because of this councils have to invest in their community if growth is expected and planned for, with development contributions paying for a significant proportion at the time of subdivision. If growth slows unexpectedly at any stage then ratepayers will end up carrying additional debt and interest costs until the growth finally occurs. Another risk is if developers mount successful legal challenges to the amount of development contributions payable (the North Shore outcome will be an important legal precedent).

Geographical Rate Increases

In order to see if there is a geographical factor in rate increase TLAs have been assigned to areas based on regional council areas. Several regions have been combined to reduce the number of areas.

Firstly the change in total rates (GST exclusive) between 2006/07 and 2015/16 is analysed. The analysis totals rates within each area and measures the change from 2006/07 to 2015/16 so each geographical area is effectively weighted by size of the rates take of each council. Results are displayed in the table below. This highlights the fact that Auckland stands out as the major driver to high rates increases, while every region south of Auckland on average is expecting rates increases less than the national average.

Table 9: Rates increases by geographic area 2007 to 2016.

Geographical Area	% Change Total rates 2006/07 to 2015/16
Otago / Southland	49%
Canterbury / West Coast	57%
Top of the South	57%
Wellington region	41%
Hawkes Bay East Cape	37%
Taranaki Manawatu Wanganui	60%
Bay Of Plenty	64%
Waikato	60%
Auckland	91%
Northland	71%
New Zealand Average	64%

Source: Local Authority Funding Project, 2006 – 2016 LTCCPs

The second rates measure analysed by geographic area is the level of rates per household from 2006/07 to 2015/16. This takes the effects of growth in households into account. This analysis is a simple average of the amount of rates per household so it treats each council as an equal with no weighting.

The effects of strong growth bring the Auckland and Bay of Plenty rate increases down in particular, although Auckland still tops the regional areas. The forecast increase in the CPI is around 20% over the same period.

Table 10: Rates increases per household by geographic area 2007 to 2016.

Geographical Area	Rates % Change per household 2006/07 to 2015/16
Otago / Southland	38%
Canterbury / West Coast	34%
Top of the South	31%
Wellington region	30%
Hawkes Bay East Cape	35%
Taranaki Manawatu Wanganui	47%
Bay Of Plenty	37%
Waikato	44%
Auckland	62%
Northland	57%
New Zealand Average	48%

Source: Local Authority Funding Project, 2006 – 2016 LTCCPs and Statistics New Zealand

Pricing Comparisons

Rates, House Prices and CPI

Rates have increased faster than general inflation, as measured by the Consumer Price Index¹², over the last 10 years. While rates have increased by 74% between the year ended December 1996 and the year ended December 2006, the CPI has increased by just 22% over the same period. The mix of costs of providing local authority services are not the same as that represented by the CPI. An analysis of more relevant price indices is carried out in the Price Indices section below.

While local authorities' costs are different to the CPI, for many ratepayers the CPI is a fair reflection of the changes to their income levels. Superannuatants and beneficiaries have their fixed incomes linked to changes in the CPI. Also many working home-owners income level changes are closer to the CPI than construction based indices. The result is that the proportion of rates to average household incomes over the last four years in particular has increased significantly.

A different picture is seen when comparing rates to the average residential house price. The house price index (QV residential house price index¹³) has increased by 103% between the year ended December 1996 and the year ended September 2006. This has resulted in rates as a proportion of residential house values falling by 17% over the last 10 years.

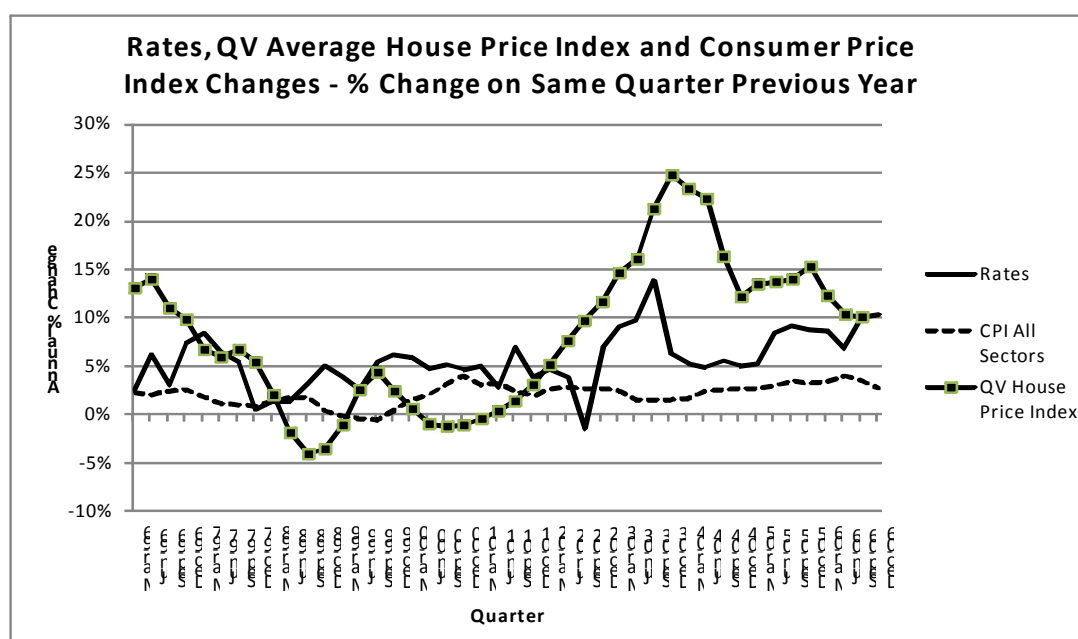


Chart 25 Rates, House prices and CPI % change 1996 to 2006. Source: Local Authority Funding Project, Statistics New Zealand CPI and RBNZ

¹² Source Statistics NZ December 2006 CPI and long term linked series

¹³ Source Reserve Bank New Zealand and Quotable Value

Price Indices

The mix of costs of providing local authority services are not the same as that represented by the CPI. More relevant price indices are available from Statistics NZ and are extensively used by local authorities in contract price escalation clauses. One of these is the Capital Goods Price Index¹⁴ that measures the cost of a range of machinery and infrastructural type assets. Two of these series are very relevant to local authorities; the cost of the commodities that make up building roads and of pipelines. The price changes for these items are heavily influenced by the international price of oil, the exchange rate and world economic demand. The Roothing Ways price index has increased by 37% from December 1998 to December 2006, compared to the CPI at 21% for the same period. The comparable increase for rates is 61%. The Pipelines price index has increased by 42% from December 1998 to December 2006.

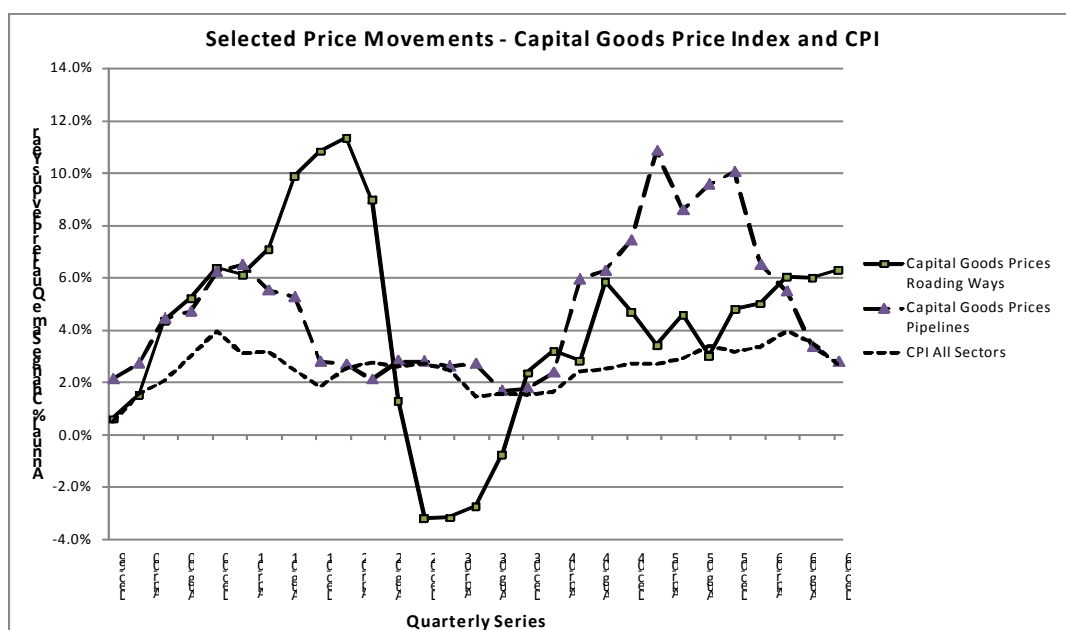


Chart 26 Capital goods and CPI price changes 1999 to 2006. Source: Statistics New Zealand CPI and Capital Goods Price Index

Other relevant price indices include the Producers Price Index¹⁵, both the local government input prices series and the construction output price series. Both of these series show that while input prices had generally tracked the CPI from the mid 1990's to 2002, since then the costs to local authorities have been increasing significantly faster than the CPI.

¹⁴ Statistics New Zealand Capital Goods Price Index December 2006

¹⁵ Source Statistics New Zealand Producers Price Index December 2006

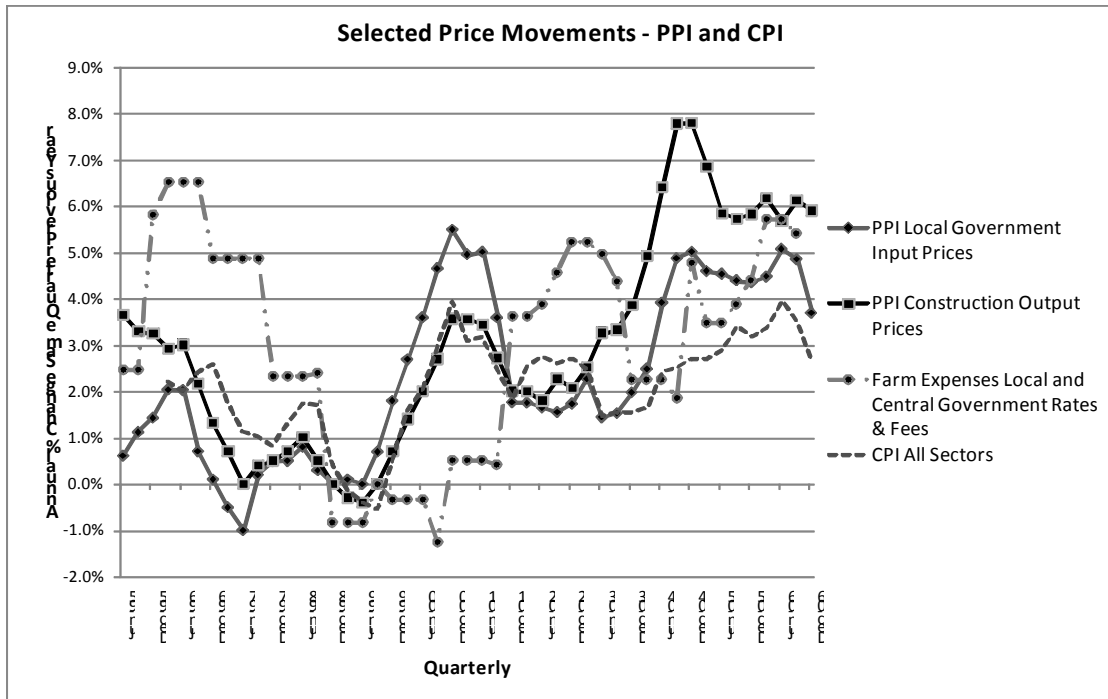


Chart 27 Changes in PPI, CPI and Farm Price indices 1994 to 2006. Source: Statistics New Zealand PPI, CPI and Farm Expenses Price Index

Funding Project Analysis Comment

There are a number of minor problems with the data sets used for the Funding Project, generally some missing data from individual councils and a few small errors. Overall these problems did not affect the overall analysis.

Of more concern is the reliance on household based ratio analysis to determine the impact on communities. The argument was that businesses and other non residential rateable properties are generally owned by homeowners and that all costs eventually are borne by households. The problem with this is that a number of metropolitan councils have extensive business communities that pay a large share of the overall rates. Many of these business owners and employees live in neighbouring councils. The impact on farming is unable to be analysed. An alternative measure is using rateable properties and this is planned to be done as a comparative. While large business communities will still skew the results to some extent it will give a better picture of the impact of rates on the rating base of each council.

Another issue with using household numbers is the difficulty in capturing holiday homes, and the fact that these rates are paid by owners who reside in another district.

The Funding Project recognised all these limitations but decided to use households as it was thought that local authorities had different methods of forecasting rateable properties, if they were available at all. Also rateable properties were not available at sub-council levels. These concerns are valid and it has proven extremely difficult just to compile rateable properties for each council for 2006/07, let alone 2015/16. Having said that a council level comparative analysis using rateable properties will provide a good check of the affordability ratios, particularly in councils with large a business sector or a high proportion of absentee holiday home owners.

The further analysis contained in this report generally confirms the main conclusions of the Funding Project:

- There is not a systemic problem
- Rates increases are being driven by investment in infrastructure and the costs of maintaining existing infrastructure
- Local Authorities are taking on significantly more debt but as a sector this is not a concern
- Rates are expected to increase significantly over the level of inflation, but by only a moderate level after accounting for growth

It also adds more details and cautions against a simple one fix for all approach:

- Some (less than 10%) of local authorities are struggling and/or are planning to take on levels of debt that is seen as being above prudent levels
- The sector is becoming more reliant on development contributions and this will increase risk levels
- The largest increases in rates, capital expenditure, debt and other measures are from the metropolitan councils – is the rates problem a reaction to past underfunding in these councils?

- Many rural and provincial councils have no real problems and would not appreciate solutions that impose more costs upon them
- Rates are expected to increase faster than expenditure due to a difficulty in increasing other income
- Some communities will need to reconsider their levels of service as costs continue to rise
- Geographically the Auckland region is the driver for high rates increases over the next 10 years.

This report questions a number of areas of accuracy in the LTCCP forecasts. Forecasts of expenditure and revenue, particularly other (non-rate) income, show signs of a lack of detail as the forecasts go past year seven. Capital expenditure is concentrated in the early years and given past performance across the sector these forecasts will not be achieved. The result is likely to be a flattening out of the capital expenditure line and the transfer of some of the rates increases from years two and three to further into the medium term. It is possible that it was politically more difficult to signal significant increases in user charges (pools, reserves, landfills, cemeteries, building fees etc) into the medium term than to show higher general rates charges.

What is apparent from the LTCCPs is the number of communities in the process of building better water and wastewater systems and new aquatic centres and other community infrastructure. In many of these communities rates are forecast to rise significantly. In these communities the problem of higher rates is at least partially self inflicted – higher levels of service could be deferred for a number of years. The Funding Project could have made more of an issue on this point. You cannot build a large number of community assets in a relatively short period of time and expect rates to remain the same. In many well established urban areas these facilities took many decades to establish and pay for.

Given the very large increases in rates forecast for the Auckland regional area the ‘rates issue’ may in fact largely be an Auckland issue rather than a New Zealand one.

The LTCCP forecasts provide a reasonable feel for how a council is planning for infrastructure over time. Nothing is more certain than that additional projects and activities will arise over time, costs will change and some projects will be dropped. The drivers work being carried out by GHD will provide more of a feel for the accuracy and risks of these LTCCPs. My assessment is that, given the current legislation, the risks to these rates forecasts are on the upside.

Appendix 1

Project Terms of Reference

The Local Government Rates Inquiry terms of reference asks it to “Examine the level of rates, level of rates increases ... “.

A review needed to be undertaken critically considering the Funding Project’s analysis of trends in rates and rates increases and graphically presenting the data. Analysis of historical data on rates versus GDP and house prices needs to be included along with a specific analysis on rates impacts on rural land and businesses.

Objective of this project

Critically review the work of the Funding Project analysis of the level of rates, rates trends and forecast rate increases. Where information is lacking develop data series where possible. Provide the Independent Rates Inquiry with a summary of this information with graphics.

Scope of Issues to be covered

The Independent Rates Inquiry needs a critically reviewed information base of rates data from which to base their recommendations. The rating trends information needs to include:

- Geographical analysis
- Rural, provincial and metropolitan analysis
- Rates per rateable property as well as households
- Business, farming and residential analysis where possible
- Rating levels on low value households
- Rating trends in high growth / low growth local authorities
- Inflation adjusted (real) trends
- Assessment of Funding Project analysis

Appendix 2

Methodology

This report was focused on providing a picture of trends in historical and forecast rates levels. As rates is the end result of a complicated process involving expenditure and other revenue sources these other factors were also analysed. To do this the data available from the Funding Project needed to be expanded and further analysed. Detailed analysis of affordability measures to individual councils, communities and individuals was not further analysed for three reasons:

- The Funding Project carried out extensive detailed work on this issue
- The consultancy projects being carried out by BERL addresses this issue
- Data series to analyse impacts on categories of ratepayers are not available

In order to provide a comparative overall analysis of rating impacts a series of the number of rateable properties used in the 2006/07 LTCCPs was developed. This is a difficult task due to the lack of reporting of this fundamental data by some councils.

All forecast local government financial data series are sourced from the 2006 – 2106 Long Term Council Community Plans. Data was compiled by extracting information from all published LTCCPs via council websites. The following data series were prepared by DIA:

- Total Rates (GST Inclusive and Exclusive)
- Total Debt
- Total Assets
- Capital Expenditure by category
- Total Interest Expenses

Household numbers were compiled by DIA using the 2001 census as a base.

The following series was compiled by Thomas Consulting:

- Operating Expenditure
- Operating Revenue
- Depreciation
- Development Contributions
- Other revenue

In some cases follow up with individual councils was required to source correct data.

Historical local government funding and expenditure data was sourced from Statistics New Zealand series Local Authority Statistics. Historical price change information was sourced from the following Statistics New Zealand series:

- Producers Price Index
- Consumers Price Index
- Farm Price Index
- Capital Goods Price Index