

## **2. INFLATION ADJUSTORS**

|                                     |                                    |
|-------------------------------------|------------------------------------|
| <b>General Manager responsible:</b> | General Manager Corporate Services |
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### **PURPOSE OF REPORT**

1. In December the Subcommittee authorised the General Manager Corporate Services to set inflation rates for both OPEX and CAPEX for the 2008-2010 years. The purpose of this paper is to brief the Subcommittee on the decisions made.

### **EXECUTIVE SUMMARY**

2. In November 2005 a representative from Beca Carter gave a presentation to the Council in which he spoke about the inflationary pressures that are being experienced within the construction industry.
3. Beca Carter are forecasting increases of between 5-6% in 2006/07, reducing to 3% for 2007/08.
4. In determining the CAPEX inflation adjustors to be applied to the LTCCP, staff were concerned that the BERL adjustors were too low and have therefore relied upon the Beca Carter figures for the 2006 and 2007 years. Remaining years are calculated using the BERL figures.
5. Within OPEX, key infrastructure contracts for the 2006/07 year have been increased by 5.5% in line with known cost increases. Salary and wages have been increased by 2.4%, and other costs held at 2005/06 dollars.
6. The OPEX weighted average adjustors for the remaining years have been calculated using the BERL indicators for the energy, staff and "other" rates (Table 1) for operating revenue and operating expenditure.
7. The weighted average rates for the years 2008-2010 are:

|                              | <b>2007/08</b> | <b>2008/09</b> | <b>2009/10</b> |
|------------------------------|----------------|----------------|----------------|
| <b>Operating Expenditure</b> | 2.91           | 2.74           | 2.54           |
| <b>Revenue</b>               | 3.18           | 2.98           | 2.74           |
| <b>CAPEX</b>                 | 3.64           | 3.41           | 3.15           |

### **STAFF RECOMMENDATIONS**

It is recommended that the Subcommittee receive this report.

## BACKGROUND ON INFLATION ADJUSTORS

8. Unlike the 2004/14 version of the LTCCP, the 2006/16 plan that we are working on is required to be audited. The Office of the Auditor General (OAG) has signalled that the financial statements contained within the document must include a robust assumption in relation to future price changes.
9. The rationale for requiring future price changes to be included in the prospective financial statements is contained within section 93 (6) of the Local Government Act 2002 which states the purposes of a LTCCP and includes:

*“(e) provide a basis for accountability of the local authority to the community; and (f) provide an opportunity for participation by the public in decision making processes on activities to be undertaken by the local authority.”*
10. Omitting the expected impact of future price changes will in most cases underestimate the true cost of activities and therefore call into question whether the financials are a ‘reasonable basis’. The financial statements must comply with generally accepted accounting practice (s111).
11. Generally accepted accounting practice requires that “prospective financial information” is prepared on “best estimate assumptions” (FRS29). Best estimate assumptions are what the organisation realistically expects to occur. “To be supportable, best estimate assumptions need to be based on the past performance of the entity itself and the prevailing economic environment”. FRS29 (5.22).
12. The Society of Local Government Managers (SOLGM) and the OAG commissioned Business and Economic Research Limited (BERL) to develop appropriate “price level change adjustors” and these are detailed in tables 1-3 below. BERL have forecast one adjustor for each of the following six categories for the period through to 2017:
  - roading and transport costs
  - property, reserves and parks costs
  - water-clean and dirty- including pipeline costs
  - staff costs
  - energy costs
  - other adjustor for local government costs.
13. Table 1 lists the annual percentage change for each of the adjustors.

**Table 1**

| Year ending | Road | Property | Water | Energy | Staff | Other |
|-------------|------|----------|-------|--------|-------|-------|
| Jun 06      | 3.2  | 3.4      | 5.3   | 6.0    | 3.3   | 2.8   |
| Jun 07      | 2.4  | 2.8      | 4.1   | 3.9    | 2.4   | 3.0   |
| Jun 08      | 2.6  | 2.9      | 4.2   | 4.1    | 2.5   | 3.1   |
| Jun 09      | 2.4  | 2.7      | 4.0   | 3.8    | 2.4   | 2.9   |
| Jun 10      | 2.2  | 2.5      | 3.7   | 3.6    | 2.2   | 2.7   |
| Jun 11      | 2.0  | 2.3      | 3.4   | 3.3    | 2.0   | 2.5   |
| Jun 12      | 1.9  | 2.1      | 3.1   | 3.0    | 1.8   | 2.3   |
| Jun 13      | 1.7  | 1.9      | 2.8   | 2.8    | 1.7   | 2.1   |
| Jun 14      | 1.5  | 1.7      | 2.6   | 2.5    | 1.5   | 1.9   |
| Jun 15      | 1.3  | 1.5      | 2.3   | 2.2    | 1.3   | 1.6   |
| Jun 16      | 1.3  | 1.5      | 2.3   | 2.2    | 1.3   | 1.6   |
| Jun 17      | 1.3  | 1.5      | 2.3   | 2.2    | 1.3   | 1.9   |

14. These adjustors are intended to be applied to operating expenditure. The first three are intended to be applied to input categories, the last three to input costs.
15. In addition, BERL have forecast a further three adjustors to be used for capital expenditure.

16. These additional adjustors are:

- pipeline costs (a sub-component of water costs)
- earthmoving costs (a sub-component of property, reserves and parks)
- private sector salary and wage costs (a sub-component of adjustors 1-4 above).

17. Table 2 lists the annual percentage change for the capital adjustors.

**Table 2**

| Year ending | Pipelines | Earthmoving | Pvte sector labour |
|-------------|-----------|-------------|--------------------|
| Jun 07      | 4.4       | 3.2         | 2.4                |
| Jun 08      | 4.6       | 3.4         | 2.5                |
| Jun 09      | 4.3       | 3.2         | 2.4                |
| Jun 10      | 4.0       | 2.9         | 2.2                |
| Jun 11      | 3.7       | 2.7         | 2.0                |
| Jun 12      | 3.4       | 2.5         | 1.8                |
| Jun 13      | 3.1       | 2.2         | 1.7                |
| Jun 14      | 2.8       | 2.0         | 1.5                |
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#### **REFERENCE**

24. This paper was prepared using data from the following sources:

- Assumptions For Price Level Changes In The Long Term Council Community Plan; NZ Society of Local Government Managers, 2005.
- BERL Forecasts of Price Level Change Adjustors; Nana G., Arcus M. Aug 2005.