

# PYRENEES SHIRE COUNCIL

Decision on application for a higher cap for 2016-17

May 2016

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## 1. OUR DECISION

The Fair Go Rates System (FGRS), established in the *Local Government Act 1989* (the Act), requires local councils to limit their average annual rate increases to a rate cap, determined annually by the Minister for Local Government (the Minister).<sup>1</sup> For the 2016-17 rating year, the cap has been set at 2.5 per cent.

Councils wishing to increase their average annual rates by more than 2.5 per cent in 2016-17 must first obtain approval from the Essential Services Commission (the Commission). We are responsible for approving, rejecting or approving in part the higher cap sought by council. This paper outlines our decision in response to an application by Pyrenees Shire Council (Pyrenees or Council) for a higher cap of 3.83 per cent (which includes the Minister's rate cap of 2.5 per cent) to apply in 2016-17.

In assessing applications, we are required to have regard to the six legislative matters<sup>2</sup> and the statutory objectives<sup>3</sup> of the FGRS (box 1).

The six legislative matters are:

- the proposed higher cap for each specified financial year
- the reason for which the council seeks the higher cap
- how the views of ratepayers and the community have been taken into account in proposing the higher cap
- how the higher cap is an efficient use of council resources and represents value for money
- whether consideration has been given to reprioritising proposed expenditures and alternative funding options and why those options are not adequate and
- that the assumptions and proposals in the application are consistent with the council's long-term strategy and financial management policies set out in the council's planning documents and annual budget.

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<sup>1</sup> Sections 185B and 185C of the *Local Government Act* define rates for the purposes of the cap.

<sup>2</sup> Section 185E of the *Local Government Act*.

<sup>3</sup> Section 10E(7) of the *Essential Services Commission Act 2001* and section 185A of the *Local Government Act*.

## **BOX 1 OBJECTIVES OF THE FAIR GO RATES SYSTEM**

- to promote the long-term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure and
- to ensure that a council has the financial capacity to perform its duties and functions and exercise its powers.

The Act also requires the Commission to have regard to a council's record of compliance with previous years' caps.<sup>4</sup> However, as this is the first year of the FGRS, this has not been a relevant consideration when assessing applications for higher caps in the 2016-17 rating year.

## **BOX 2 COMMISSION'S DECISION ON PYRENEES SHIRE'S APPLICATION**

Pyrenees has applied for a higher cap of 3.83 per cent, that is, 1.33 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Pyrenees' application, and decided to approve its higher cap of 3.83 per cent for 2016-17.

On balance, the Commission is satisfied that a higher cap is appropriate for 2016-17 because Pyrenees does not otherwise have sufficient options to increase its road renewal expenditure for 2016-17.

However, the Commission considers Pyrenees should undertake a more strategic infrastructure need assessment, including seeking views from the community and ratepayers on infrastructure need and affordability as part of its long-term financial planning as a matter of urgency.

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<sup>4</sup> Section 185E(6)(c) of the Local Government Act.

## 2. WHAT DID THE COUNCIL APPLY FOR AND WHY?

Pyrenees sought a 3.83 per cent rate cap for 2016-17 (inclusive of the Minister's rate cap of 2.5 per cent). Pyrenees estimated that this would result in additional revenue of \$97 748.

In applying for the higher cap, Council resolved to use the additional funds to increase spending on road infrastructure asset renewal (in particular sealed surfaces) and reduce the infrastructure renewal gap.<sup>5</sup> It has advised that the additional revenue will be quarantined to road reseals for the life of its Long-term Financial Plan (LTFP) 2016-26.<sup>6</sup>

A copy of Pyrenees' application and its response to our request for information (RFI) is available on our website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)). Appendix A shows the communications between the Commission and Pyrenees during the assessment period.

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<sup>5</sup> Pyrenees Shire Council 2016, *Higher cap application*, March, p.4.

<sup>6</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, p. 2.

### 3. HOW DID WE REACH OUR DECISION?

Table 1 summarises the Commission’s observations on each of the relevant matters specified in Pyrenees’ application.

**TABLE 1 LEGISLATIVE MATTER SUMMARY**

Legislative matter	Summary
185E(3)(a) — proposed higher cap	The Commission verified that the higher cap was appropriately calculated. <sup>a</sup>
185E(3)(b) — reason(s) for which the Council seeks the higher cap	<p data-bbox="576 607 1361 801">Council’s need to increase its asset renewal expenditure is supported by an assessment undertaken by Moloney Asset Management Systems(MAMS) in December 2015. This assessment found that the condition of sealed surfaces had declined since the previous survey in 2011 and recommended increased asset renewal expenditure to prevent more costly reconstruction expenses in the future.<sup>b</sup></p> <p data-bbox="576 808 1361 936">The Commission is satisfied that Council’s application demonstrates that it needs to increase asset renewal expenditure and notes Council’s resolution to quarantine the additional revenue to road reseals for the life of its Long-term Financial Plan.</p> <p data-bbox="576 943 1361 1572">While the Commission is satisfied that Council will use the revenue from the higher cap to fund asset renewal, there are some inconsistencies within its application and recent draft financial documents regarding how Council would respond should its application not be approved. Pyrenees completed our Budget Baseline Information template, which indicated that the only difference between the ‘with higher cap’ and ‘without higher cap’ scenarios would be higher asset renewal expenditure with a higher cap. This is consistent with figures contained in Pyrenees’ recent draft 2016-17 Annual Budget and LTFP 2015-16 to 2025-26 (both showing ‘with’ and ‘without’ higher cap scenarios). However, despite these figures showing no difference in operational expenditure between the two scenarios, Pyrenees has advised the Commission that it is yet to determine what it would do if its application was not successful, and has not ruled out service reductions in 2016-17 and subsequent years.<sup>c</sup> We consider that, if services would change between the ‘with’ and ‘without’ cap scenarios, then Council’s reason for applying for the higher cap may be more accurately characterised as being to maintain existing service levels. As it is, we have assessed Council’s application based on the data presented to the Commission in the Budget Baseline Information — that is, that the reason for the higher cap is to fund asset renewal, rather than to maintain services.</p>

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**TABLE 1 (CONTINUED)**

Legislative matter	Summary
<p>185E(3)(c) — how the views of ratepayers and the community have been taken into account in proposing the higher cap</p>	<p>Pyrenees' application sets out its comprehensive consultation plan to consult with its community in February and March 2016 about its proposal to increase rates by 2 per cent above the Minister's rate cap to improve the long-term condition of the shire's roads.<sup>d</sup> This plan involved an online survey, newspaper advertisement, facebook notices, a printed brochure, one-on-one meetings and community meetings.<sup>e</sup> Although participation in the consultation was low, we acknowledge the efforts of Council to engage with its community within the time available, using a broader range of media than its usual budget consultation processes.<sup>f</sup></p> <p>The outcome of Council's consultation seems to have been broad support for additional expenditure on sealed road renewal, but a lack of consensus on how this expenditure should be funded. Feedback during the consultation included suggestions that additional funding should come from the State or Federal Government, or from efficiency savings within council, or through service reviews. Council's application indicated that participants (particularly farmers) said they did not have the capacity to pay additional rates.<sup>e,f</sup></p> <p>Council's application explained that it responded to this feedback with a resolution to seek more funding from State and Federal Governments.<sup>a,e</sup> It has also advised that it is in the process of conducting service reviews and has already identified cost savings and efficiencies to cover the lost income from the freeze on Federal Assistance Grants and the cap on rates.<sup>g</sup> Further, in applying for a higher cap, Council revised down its proposed additional rates increase from 2 per cent to 1.33 per cent.<sup>e</sup></p> <p>We note that Council's consultation did not address the trade-offs that would be made without the additional revenue from the higher cap. Although the summary report presented to Council indicated that service cuts and trade-offs were considered in the one-on-one and community meetings, respondents to the online survey were only asked whether or not they supported an increase in rates to fund roads renewal.<sup>e</sup> There is no clear evidence in Pyrenees' application that Council indicated to the community that services might be cut or reduced if its application for a higher cap was not successful.<sup>h</sup></p>
<p>185E(3)(d) — how the higher cap is an efficient use of Council resources and represents value for money</p>	<p>Council's application has outlined a range of ways in which it is delivering value for money to its ratepayers, including service review efficiencies, improved procurement practices, utilisation of shared services, improved management of council fleet, reduction in staff and consultant costs and improved utilisation and efficiency of plant and equipment.<sup>g</sup></p> <p>Of particular relevance to Council's application for additional revenue to fund road resealing is its involvement in the Central Highlands Regional Procurement Network, which it says has led to improved efficiency of road infrastructure costs.<sup>i</sup> Council estimates savings of \$630 000 per annum collectively among the five participating councils.<sup>j</sup></p> <p>Pyrenees' road reconstruction and resealing costs also compare favourably to the average for similar councils, as reported by the Department of Environment, Land, Water and Planning.<sup>k</sup></p>

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**TABLE 1 (CONTINUED)**

Legislative matter	Summary
<p>185E(3)(e) — whether consideration has been given to reprioritising proposed expenditures and alternative funding options and why those options are not adequate</p>	<p>Council has outlined possible alternative funding options in its application, including increases in fees and charges, or reductions in operating expenditure, capital spending or service provision.</p> <p>Council concluded that there is little scope to increase fees and charges, with most being determined by legislation or commercial competition.<sup>l</sup></p> <p>Council's application sets out how it has made progress in reducing its operating expenditure and has been able to absorb the impact of rate capping and the freezing of Financial Assistance Grants to achieve a balanced budget on a cash basis for 2016-17 within the rate cap of 2.5 per cent.<sup>g,m</sup> However, it still has a significant adjusted underlying deficit driven by a large depreciation cost<sup>n</sup> and believes it is unable to fund additional asset renewal from current revenue without reducing service levels.<sup>o</sup> While reductions to services such as school crossing supervisors and home and community services are mooted in its application, Council notes that 'given the isolation and level of disadvantage in the Pyrenees shire any reduction in service will be felt by those least able to cope'.<sup>o</sup> Council also notes that its consultation did not yield any consensus on service reductions and that the cost benefit of all Council services would need to be considered.<sup>p</sup> Council is currently in the process of conducting service reviews, which it says will take time and will be an ongoing process.</p> <p>Council is currently planning to be debt-free by the end of 2017-18<sup>q</sup> and states in its application that 'it does not view borrowings as an alternative, as it considers it would limit its long-term financial strategy of using borrowings to fund large unforeseen expenditure items and large capital investment projects that are intergenerational (pools and community facilities)'.<sup>r</sup></p>
<p>185E(3)(f) — that the assumptions and proposals in the application are consistent with the Council's long-term strategy and financial management policies set out in the Council's planning documents and annual budget</p>	<p>Council's application linked its need to increase its asset renewal expenditure to a report prepared by MAMS, which recommended \$912 000 be spent on road reseals in 2016-17 (compared to Council's budgeted amount of \$770 000 without a higher cap).<sup>r</sup> Council says the additional roads renewal expenditure for which the higher cap is sought is consistent with the goal in its Council Plan to improve the rate at which Council reseals its roads, and with the broad financial strategy in its Road Asset Management Plan of shifting funding into areas which are below recommended funding levels.<sup>s</sup></p> <p>However, the Commission has found it difficult to reconcile the amount of additional revenue sought by Council with any expenditure levels or financial targets in its budget and planning documents, due to a number of factors including:</p> <ul style="list-style-type: none"> <li>• The MAMS report<sup>s</sup> was prepared in December 2015 and finalised in March 2016, after the Council Plan,<sup>u</sup> Long-term Financial Plan (LTFP) and Strategic Resource Plan (SRP)<sup>v</sup> were prepared</li> <li>• The recommendations in the MAMS report relate to target levels of over intervention assets, which is different from Council's SRP and LTFP which report asset renewal ratios but do not refer to specific Council target levels, and the Council Plan which includes a target per cent of sealed roads to be resealed within the given year</li> </ul>

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**TABLE 1 (CONTINUED)**

Legislative matter	Summary
185E(3)(f) (continued)	<ul style="list-style-type: none"> <li>• The SRP and LTFP referenced in Council's application were prepared prior to the introduction of the FGRS and were based on rate increases of between 4 and 5.15 per cent<sup>w</sup></li> <li>• Council has reduced its operating expenditure since its SRP and LTFP were developed and is planning further service reviews that may lead to further expenditure reductions<sup>g</sup> — potentially enabling existing resources to be redirected to asset renewal</li> <li>• Council has stated it is not applying for the full amount needed to address the renewal gap for sealed surfaces in recognition of the community's capacity to pay rates<sup>x</sup></li> <li>• The higher cap applied for by Council has been determined by reference to Council's previously proposed rate increase in its SRP rather than to a specific expenditure need or target level of road renewal</li> </ul> <p>Although Council's application would have benefited from clearer linkages to its planning (and explanations of relevant differences), the Commission is satisfied that Council's latest draft LTFP (with a higher cap) shows an increase in expenditure on road reseals over the long-term and the quarantining of additional revenue from the higher cap for this purpose.<sup>y,z</sup></p>

<sup>a</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, p. i. <sup>b</sup> Pyrenees Shire Council 2016, *Higher Cap Application — Appendix 1: Moloney Asset Management Systems Report*, March, p. 29. <sup>c</sup> See for example Pyrenees Shire Council 2016, *Higher Cap Application*, March, p. 26 and Pyrenees Shire Council 2016, *Response to request for information*, p. 20. <sup>d</sup> Pyrenees Shire Council 2016, *Higher Cap Application — Appendix 6: Fair Go Rates Submission Plan, and Appendix 7: Council Report Fair Go Rates Submission Plan, 16 February 2016*, March. <sup>e</sup> Pyrenees Shire Council 2016, *Higher Cap Application — Appendix 8, Council Report Fair Go Rates Higher Cap Submissions, 15 March 2016*, March. <sup>f</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, pp. 9-12. <sup>g</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, pp. 25-26. <sup>h</sup> Pyrenees Shire Council 2016, *Response to request for information — Attachment 'Higher Cap Submission: Have Your Say'*, Presentation, April. <sup>i</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, pp. 23-24. <sup>j</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, p. 14. <sup>k</sup> Department of Environment Land, Water and Planning 2015, *Know Your Council*, <https://knowyourcouncil.vic.gov.au>, accessed on 16 May 2016. <sup>l</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, p. 27. <sup>m</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, p. 8. <sup>n</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, pp. 22-23. <sup>o</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, p. 26. <sup>p</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, p. 11. <sup>q</sup> Pyrenees Shire Council 2016, *Higher Cap Application — Appendix 4: 2015-16 Budget and Long Term Financial Plan '10.1 Borrowings'*, March. <sup>r</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, p. iv. <sup>s</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, pp. 3, 5-6. <sup>t</sup> Pyrenees Shire Council 2016, *Higher Cap Application — Appendix 1: Moloney Asset Management System Report*, March. <sup>u</sup> Pyrenees Shire Council 2016, *Response to request for information — Attachment "Council Plan 2013-17, Updated November 2015"*, April. <sup>v</sup> Pyrenees Shire Council 2016, *Higher Cap Application — Appendix 4: 2015-16 Budget and Long Term Financial Plan*, March. <sup>w</sup> Pyrenees Shire Council 2016, *Higher Cap Application — Appendix 4: 2015-16 Budget and Long Term Financial Plan*, March, p. 13. <sup>x</sup> Pyrenees Shire Council 2016, *Response to request for information*, p. 4. <sup>y</sup> Pyrenees Shire Council 2016, *Response to request for information, Attachment 'Draft Long Term Financial Plan 2015-16 to 2025-26, 3.83 per cent rate rise*. <sup>z</sup> Pyrenees Shire Council 2016, *Response to request for information, Attachment 'Draft Long Term Financial Plan 2015-16 to 2025-26, 2.5 per cent rate rise*.

### 3.1 ASSESSMENT

As required under the FGRS, we have examined each of the six legislative matters addressed in Pyrenees' application. The legislation also requires the Commission to (i) promote the long term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure; and (ii) ensure that a council has the financial capacity to perform its duties and functions and exercise its powers.

Taking into account all of the relevant factors above, the Commission formed the view that the higher cap is appropriate for the following reasons:

- Pyrenees is already operating with a substantial negative adjusted underlying result.
- Pyrenees has demonstrated a long-term need to increase expenditure on asset renewal to maintain current service levels.
- Council has outlined measures it has already taken to reduce its operating expenditure.
- Council is planning to undertake further service reviews over the next two years that may lead to further reductions in operating expenditure.

#### **UNDERLYING FINANCIAL POSITION AND DEMONSTRATED NEED FOR A PERMANENT INCREASE TO THE RATE BASE**

To justify a permanent increase to the rate base, Council should demonstrate a long-term financial need that is consistent with the long-term interests of its ratepayers and community for sustainable outcomes in service delivery and critical infrastructure.

We have examined Pyrenees' underlying financial position. Pyrenees has provided forecasts of the impacts on its Local Government Performance Reporting Framework (LGPRF) financial indicators (under both 'with' and 'without' higher cap scenarios).<sup>7</sup> These forecasts show that Pyrenees continues to operate with a significant negative adjusted underlying result in the short- and medium-term. The forecasts also show that its asset renewal ratio will be higher under the 'with higher cap' scenario, consistent

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<sup>7</sup> Pyrenees Shire Council 2016, *Budget Report 2016-17, Proposed Budget, Option 1 — 2.5 per cent rate rise*, p. 39.

with its commitment to quarantine additional revenue from the higher cap to road reseals<sup>8</sup> (table 2).

**TABLE 2 LOCAL GOVERNMENT PERFORMANCE REPORTING FRAMEWORK INDICATORS**

LGPRF indicator <sup>a</sup>	2014-15 (Actual)	2015-16 (Budget)	2016-17 (Forecast)	2017-18 (Forecast)	2018-19 (Forecast)
<b>Operating position<sup>b</sup></b>					
<b>Adjusted underlying result<sup>c</sup> (%)</b>					
pre-FGRS	-10.7	-51.4			
'without' higher cap (a)			-23.6	-46.0	-48.0
'with' higher cap (b)			-22.9	-45.2	-47.1
difference (b-a)			0.7	0.8	0.9
<b>Obligations<sup>b</sup></b>					
<b>Asset renewal (%)</b>					
pre-FGRS	61.7	97.5			
'without' higher cap (a)			104.8	63.4	60.4
'with' higher cap (b)			106.3	64.8	61.8
difference (b-a)			1.5	1.4	1.4

**Note:** With and without higher cap forecasts assume a rate increase of 2.5 per cent per year beyond 2016-17 (Pyrenees Shire Council 2016, *Budget Report 2016-17, Proposed Budget, Option 1 — 2.5 per cent rate rise*, p. 39). <sup>a</sup> Table only includes LGPRF indicators considered in making our decision. <sup>b</sup> See Appendix B for definitions of these indicators. <sup>c</sup> Pyrenees has excluded Roads to Recovery funding from these calculations (Pyrenees Shire Council 2016, pers. comm., 13 May 2016).

Data source: Pyrenees Shire Council 2016, *Response to request for information*, April.

Pyrenees is already operating with a substantial a negative adjusted underlying result and claims that the combined impact of rate capping and the freeze on indexation of Financial Assistance Grants has been significant.<sup>9</sup> Council has outlined measures it has already taken to reduce its operating expenditure and states that it has been able to absorb these income reductions to achieve a balanced budget on a cash basis for 2016-17.<sup>10</sup>

<sup>8</sup> Pyrenees Shire Council 2016, *Response to request for information*, April, p. 2.

<sup>9</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, p. 26.

<sup>10</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, p. 26.

Council has been underfunding its asset renewal and the condition of its roads is deteriorating.<sup>11</sup> Council's latest draft Long-term Financial Plan (2016-17 to 2026-27) under both the 'with' and 'without' higher cap scenarios indicate Council's intention to increase asset renewal expenditure over the life of the plan (and by a higher amount under the 'with' higher cap scenario), consistently with the recommendations of the MAMS Report.

Council's current large asset base and related depreciation relative to income will continue to contribute to ongoing negative adjusted underlying results. In developing a plan for financial sustainability, Council will need to consult with its community and ratepayers on services and infrastructure needs and their preparedness to pay as part of its long-term financial planning.

While further service reviews planned over the next two years may lead to further reductions in operating expenditure, in the short-term we agree that Council is not in a position to increase renewal expenditure without additional revenue or service cuts. On balance, we are satisfied that a higher cap is appropriate for 2016-17 because Pyrenees is financially constrained and based on current road asset service levels, does not otherwise have sufficient options to increase its road renewal expenditure.

However, we consider Pyrenees should undertake a more strategic infrastructure need assessment, including seeking views from the community and ratepayers on infrastructure need and affordability as part of its long-term financial planning as a matter of urgency.

## **MONITORING OF OUTCOMES**

Under the FGRS framework, we are required to report annually on Pyrenees' compliance with its rate cap and every two years on outcomes from the FGRS. When doing so, we will monitor and report on whether Pyrenees has spent the funds from a higher cap in accordance with the expenditure needs cited in its application. While we approve rates and not individual expenditures, it will be important that community and ratepayers receive confirmation that Pyrenees has fulfilled its expenditure commitments. In the event that those additional funds have been redirected to other areas of expenditure, we will seek and publish Pyrenees' explanation for the reallocation of those funds.

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<sup>11</sup> Pyrenees Shire Council 2016, *Higher Cap Application*, March, pp. 28-29.

## APPENDIX A: SUMMARY OF COMMUNICATIONS WITH PYRENEES

Pyrenees submitted its application for a higher cap on 29 March 2016. In response to its application, the Commission sought additional information from Pyrenees (table 3). Pyrenees' application and its response to our request for further information can be found on our website.

**TABLE 3 COMMUNICATIONS BETWEEN PYRENEES AND THE COMMISSION**

<b>Date</b>	<b>Nature of communication</b>
29 March	Pyrenees submitted its application
15 April	Commission issued to Pyrenees a request for information (RFI)
18 April	Council queried matter in the request for further information regarding the proposed higher cap
21 April	Council contacted Commission with a query on the rate cap calculation
21 April	Pyrenees submitted its response to the RFI
22 April	Council and Commission discussed the Council query further
4 May	Commission sent a further request for information to Pyrenees
6 May	Pyrenees responded to the Commission's 4 May request
12 May	Commission sought further clarification of Pyrenees' LGPRF figures
12 May	Commission contacted Council to clarify matter in baseline information template
13 May	Pyrenees provided clarification of its LGPRF figures
13 May	Council clarified Commission query

## APPENDIX B: LGPRF INDICATOR DEFINITIONS

- a. **Adjusted underlying result** is adjusted underlying surplus (deficit) as a percentage of adjusted underlying revenue. A surplus or increasing surplus suggests an improvement in the operating position.
- Adjusted underlying revenue** is total income less non-recurrent capital grants used to fund capital expenditure, non-monetary asset contributions and other contributions to fund capital expenditure.
- Adjusted underlying surplus** is adjusted underlying revenue less total expenditure.
- b. **Asset renewal** is asset renewal expenditure as a percentage of depreciation. This indicates whether assets are being renewed as planned. High or increasing level of planned asset renewal being met suggests an improvement in the capacity to meet long-term service obligations.
- Asset renewal expenditure** is expenditure on an existing asset or on replacing an existing asset that returns the service capability of the asset to its original capability.