Deloitte Access Economics

Assistance with review of 2016-17 rate cap variation applications

City of Ballarat

Essential Services Commission

May 2016

Deloitte.

Contents

1 City of Ballarat

1.1 Project background

In 2015 the Essential Services Commission (ESC) was appointed by the Victorian Government to undertake an independent inquiry and provide advice on the introduction of a rates capping framework for local government.[1]

Following the release of the ESC's final report in October 2015, the Victorian Government established the Fair Go Rates System (FGRS) which limits the maximum amount councils may increase rates in a year without seeking additional approvals. The rate cap set by the Minister under the FGRS for 2016-17 is 2.5% for all councils.

Under the FGRS, councils can apply to the ESC for a higher cap in circumstances where the rate cap is insufficient for their specific needs. Ten local governments submitted applications for 2016-17 rate cap variations for the ESC's consideration.

The ESC has engaged Deloitte Access Economics to provide assistance with the review of the rate cap variation applications that have been submitted, to inform the ESC's decisions.

This report provides a summary of Deloitte Access Economics' review of the documentation submitted by the City of Ballarat in its application for a rate cap variation. This includes:

- an overview of the council's circumstances and their application;
- an assessment of the financial performance, position and outlook for the council; and
- concluding remarks.

This report should be read in conjunction with the Guidance Note prepared for the ESC, which sets out the key factors that Deloitte Access Economics has considered in its assessments of the applications for rate cap variations for 2016-17 and the rationale for the basis of the analysis.

1.2 Overview

Ballarat is a regional city with a population of about 100,000. It has applied for a rate increase of 1.2% above the 2.5% rate cap. It estimates that the above the cap rate increase would generate additional revenue of $1.03 million in 2016-17.

In its submission, Ballarat argues for the additional increase in order to assist in closing its renewal gap and to support in the funding of its 'Developers Contribution Scheme'. It also identifies that over the past 10 years its rate revenue base has increased by an average of 5.5% per annum and that its asset base has increased by an average of 7.5% per annum and recognises that this increase in its stock of assets is creating pressure on its capacity to

[1] State Government of Victoria, Local Government Rates Capping Framework Review, http://www.vic.gov.au/news/local-government-rates-capping-framework-review.html

maintain service levels. The extent to which this growth in its asset base has arisen from property development growth as opposed to an increase in service levels is unclear.

In 2006 the council developed a planning document, 'Blueprint Ballarat'. It identified a deficiency in funding essential capital projects to address a claimed increasing infrastructure renewal gap.

1.3 Assessment of financial performance, position and outlook

Ballarat budgeted for approximately $201 million in income in 2015-16, including $48 million in capital related grants and contributions. Budgeted rates and charges were $98 million.

Ballarat's budgeted expenses for the year were $152 million. It effectively budgeted for about a break-even adjusted underlying operating result. (Its current projections are for an adjusted underlying operating surplus ratio for the year of 12.4% in 2015-16, which suggests that there have been favourable variances since the date of budget adoption.)

Ballarat's most recent financial forecast based on a 3.7% rate increase in 2016-17 and 3.6% thereafter suggest a small underlying operating deficit over the next 5 years as shown below.

Table 1.1:Adjusted underlying result ratio

	2016-17	2017-18	2018-19	2019-20	2020-21
Adjusted underlying result ratio	-1.7%	-1.6%	-1.7%	-2.0%	-2.1%

Ballarat projects that its deficit would remain at about this level in the subsequent 5 year period too. Ballarat has also provided forward projections based on rate revenue increases in line with a 2.5% per annum rate cap. They reveal that the adjusted underlying result ratio would be about 0.5% worse each year under this scenario assuming that capital outlays would be curtailed by the difference in rate revenue each year (presumably about $1.0 million in 2016-17). This assumption therefore effectively means that its liquidity and debt levels would be practically unchanged under either option.

Ballarat's rating and broad financial strategies appear to be based primarily on generating particular levels of revenue that enable it to accommodate specific current and future proposed outlays. Deloitte Access Economics would instead recommend that it focus on achieving a modest ongoing adjusted underlying surplus. If it could realise such an outcome it would have the capacity (including through responsible use of debt as and when required) to meet peaks in future outlay needs (including for asset renewal and other capital works).

Ballarat highlights that previous reports have identified a need for it to spend more on capital works. The majority of its capital expenditure in recent years has related to acquisition of new assets and upgrading rather than renewing assets.

The table below indicates Ballarat's actual and forecast asset renewal outlays as a percentage of annual depreciation based on options of both a cap of 2.5% per annum from 2016-17 and with an a 3.7% rate increase in 2016-17 and 3.6% thereafter. In any event, it should not be assumed that asset renewal expenditure in the order of about 100% of the level of annual depreciation is necessarily desirable in any period (or even over the medium term). Asset renewal needs can be lumpy between periods and service level preferences can change over time.

Table 1.2: –Asset renewal ratio

	2014-15	2015-16	2016-17	2017-18	2018-19
With 2.5% rate cap	49%	67%	67%	65%	63%
With preferred higher rate increase	49%	67%	69%	68%	68%

In its submission Ballarat highlights that inadequate spending on asset management can result in premature asset failure and higher annualised asset management costs. This is acknowledged, however it is suggested that with careful planning regarding affordable and acceptable service levels it is also often possible to make savings in asset management outlays without premature asset failure or increases in long-run annualised asset management costs.

Ballarat has more than adequate current and projected ongoing liquidity and modest levels of debt. It has capacity to raise more debt in future if needed to accommodate large one-off (for example capital works) expenditure needs providing it implements and maintains financial strategies that generate a satisfactory ongoing adjusted underlying operating result.

1.4 Concluding remarks

Ballarat's projected ongoing adjusted underlying deficit tends to support its application for a modest increase in rates in 2016-17 above the cap. However it is not clear from the available material that it has yet developed sound and affordable plans as regards future warranted and affordable asset outlays and services.

If an increase was approved in 2016-17 the council's overall financial circumstances would little change and it is likely that it would wish to seek additional incremental rate increases in future years. If the sought after 2016-17 increase was not granted it would not present the council with any immediate financial challenges but would probably result in some proposed capital expenditure being delayed or reduced in scope.

Ballarat argues in its application that if its request is not granted it would have to consider delaying the provision of infrastructure in Ballarat West, which would in turn slow growth and negatively impact upon construction activity employment. The council could consider raising additional borrowings if necessary to avoid delaying provision of this infrastructure and avoiding the perceived associated negative consequences.

Regardless of the decision concerning the 2016-17 application (and all other things being equal) it is likely that Ballarat will over the medium to longer-term need incremental but cumulative real rate increases of the order of 10% or more in order to maintain financial sustainability. Such an increase could of course be reduced by the extent to which it could reduce future operating costs through improving efficiency and reducing service levels (including by delaying or reducing in scope expenditure on new additional assets). Ongoing growth could also help providing that associated additional long-run costs are less than additional long-run income.

Limitation of our work

Limitations

This work is not a substitute for independent financial modelling of scenarios with and without rate cap variations for each council. This work has been limited only to the review of application-related documentation submitted by councils seeking a rate cap variation and time available.

This work takes as given the financial and other data, calculations and analysis provided in the application-related documentation. It does not constitute an audit or test to verify the validity of the underlying financial data upon which the applications are based. We have not been given access to the underlying spreadsheet models, except to the extent that these have been provided as part of applications. Our analysis has not confirmed the calculations within the applications. We have not used or sought data from any other sources, except to the extent that this is cited as such in the report.

General use restriction

This report is prepared solely for the use of the Essential Services Commission. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for the purpose of assisting the Essential Services Commission with the review of 2016/17 rate cap variation applications. You should not refer to or use our name or the advice for any other purpose.

Contact us

Deloitte Access Economics
ACN: 149 633 116

550 Bourke Street
Melbourne VIC 3000
GPO Box 78
Melbourne VIC 3001 Australia

Tel: +61 3 9671 7000
Fax: +61 3 9671 7001

www.deloitteaccesseconomics.com.au

Deloitte Access Economics is Australia's pre-eminent economics advisory practice and a member of Deloitte's global economics group. For more information, please visit our website www.deloitteaccesseconomics.com.au

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 200,000 professionals are committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms. Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 6,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.