Deloitte Access Economics

Assistance with review of 2016-17 rate cap variation applications

Shire of Buloke

Essential Services Commission

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Deloitte.

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1 Shire of Buloke

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 by 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 Shire of Buloke 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

Buloke Shire Council is a small rural municipality. It has a population of about 6,000 people and this is expected to decline at a rate of between 0.5% and 1% pa over the next decade. It has applied for a rate increase of 0.55% above the 2.5% rate cap and this would generate additional revenue for it of about $56,000 in 2016-17.

Buloke has made considerable effort to reduce its costs in recent years. It has recognised the challenges that small rural councils in particular face in operating on a financially sustainable basis but is committed to doing so.

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

As part of its reforms it borrowed $7 million on an interest-only basis in 2014 in order to improve cashflow and restructure existing debt and generate savings on interest costs. The loan is due to be repaid in 2019 and the council has been carefully planning and budgeting since then in order to have the capacity to repay the loan and accommodate other planned expenditure outlays.

Buloke considers it needs the sought after increase to accommodate its future outlay needs. Its expenditure on capital works or operating activities will not vary in 2016-17 regardless of whether the increase is approved or not.

1.3 Assessment of financial performance, position and outlook

Buloke budgeted for approximately $24 million in income in 2015-16, including $1 million in non-recurrent capital related grants and contributions. Budgeted rates and charges were $12 million.

Buloke's budgeted expenses for 2015-16 were $22 million. It has budgeted for a small adjusted underlying operating surplus (effectively a break-even result). It reported results and projections for the adjusted underlying operating result ratio in its 2015-16 budget document. This data is shown below together with updates included in its rate increase application that showed forecasts with and without the impact of the rate cap.

Table 1.1: Adjusted underlying result ratio

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
2015-16 budget	-12%	3%	-1%	1%	3%	n/a
Revised projections with cap	5%	-7%	9%	-3%	-3%	-3%
Additional increase 2016-17 only	5%	-7%	9%	-2%	-2%	-2%

In order to improve its financial circumstances, and in consultation with its community, Buloke increased rates by 6% in 2014-15 and 2015-16. Its 2015-16 budget projections shown in the table above were also based on 6% per annum increases in subsequent years. At least partly as a consequence of the introduction of the rate capping framework it subsequently revised downwards its proposed increase in 2016-17.

The above table suggests that Buloke will need to generate more revenue or reduce costs further if it is to operate with a small adjusted underlying operating surplus on an ongoing basis. It would be desirable for it to strive to do so. If it can achieve this then it is likely it will be able to maintain preferred service levels consistent with that cost structure in future and be able to accommodate any peaks in asset renewal expenditure timing. (Note, it is assumed that one-off abnormal factors are responsible for the improved ratio now projected for 2016-17. This could be for example the impact of the recognition of the large and unexpected increase in 'Roads to Recovery' grants that the Commonwealth will pay next year. One-off events and their impact on the ratio should be ignored for financial strategy setting purposes and in assessing ongoing performance. Trend data instead should be the prime focus.)

Buloke has undertaken considerable asset management planning work and has identified some possible future road maintenance and renewal savings from the downgrading of the classification (effectively service level) of some roads. It has an Asset Management Policy and a Sustainable Asset Management Improvement Strategy. . It has advised that it does not have a long term financial plan (beyond its Strategic Resource Plan forward estimates). It believes it has an asset renewal gap and its pre-rate cap environment financial strategy of increasing rates by 6% per annum over the planning period was aimed at generating capacity to progressively reduce that gap.

There are some reservations regarding the consistency and objectivity with which councils determine asset renewal 'gaps'. An accumulated renewal gap is a function of, amongst other things, preferred service level decisions and revenue raising and use of debt strategies.

It is likely that Buloke's focus has been on turning around its financial performance by reducing costs and satisfying cashflow requirements. This is a sensible approach. Local government infrastructure assets are generally long-lived. A council's first priority should be to strive to operate in a financially sustainable manner. If it can achieve this, then it is likely that it will have the capacity to accommodate asset management needs cost-effectively over time.

Buloke's actual and forecast asset renewal outlays as a percentage of annual depreciation both as reported in its 2015-16 budget and strategic resource plan and currently forecast are shown in the table below. Note that proposed asset renewal outlays are not planned to vary depending on whether its application to increase rates beyond the cap in 2016-17 is approved or not.

Table 1.2: Asset renewal ratio

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
2015-16 budget	52%	82%	82%	82%	82%	n/a
Current forecast	59%	73%	92%	91%	91%	91%

In Deloitte Access Economics' view it should not be assumed that asset renewal expenditure of 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 wishes can change over time. The table above does however suggest that Buloke is now proposing to spend more on asset renewal than was forecast when it prepared its 2015-16 budget and strategic resource plan.

Buloke has more than adequate current and projected ongoing liquidity and modest levels of debt. Buloke is very keen to generate sufficient net cashflow to repay its $7 million loan in 2019 and then to be debt free and consequentially reducing its operating costs by not subsequently incurring associated interest of $336,000 per annum thereafter. It is on track to do so. In reality this interest cost represents only about 1.5% of its total operating costs. If it maintains financial strategies that generate a satisfactory ongoing adjusted underlying operating result it could raise more debt in future if needed to accommodate large one-off expenditure requirements. Given however that its population is not growing it may have little need to borrow in future.

1.4 Concluding remarks

Buloke could get by in 2016-17 without an increase in rates beyond the cap. Over time though, unless it receives more revenue from elsewhere or is able to cut costs further it is likely to need to raise more rate revenue in order to be able to operate on an ongoing financially sustainable basis.

It has undertaken good asset management and financial planning work but further work in this regard would help determine preferred, affordable long-run service levels and associated rate revenue requirements.

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.

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