Deloitte Access Economics

Assistance with review of 2016-17 rate cap variation applications

Shire of Towong

Essential Services Commission

May 2016

Deloitte.

Contents

1 Shire of Towong

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 Shire of Towong 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

Towong is a small rural council with a population of 5,900 and above average levels of social disadvantage. It is very aware of the importance of operating in a financially sustainable manner and the particular challenges for similar councils in so doing. In its application it cites an extensive list of measures it has already taken to reduce long-run costs and enhance its financial performance and position. Because of its actions to date it claims that it would find it harder than many councils to materially reduce costs further without significant adverse impact on community-preferred service levels.

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

In order to improve financial sustainability it has also been increasing average rate levels at between 4% and 6% per annum over the past 5 years.

Towong recognises the socio-economic circumstances of its community but believes residents and ratepayers would prefer rate increases in excess of the cap rather than noticeably reduced service levels. It has applied for a rate increase of 3.84% above the 2.5% rate cap. Its budgeted income for 2015-16 is $15.0 million of which approximately half is from rates and charges. It estimates that the above the cap rate increase it has sought would generate additional revenue of $242,000 in 2016-17.

Towong argues that an increase beyond the cap is needed to maintain financial sustainability and general service levels and in particular to enable it to undertake infrastructure asset maintenance and renewal at the levels it (and its asset management consultant) believe is warranted.

It has included in its proposal its projected performance for the Victorian Auditor General's Office (VAGO) 'financial sustainability risk' indicators assuming rates are limited to an assumed 2.5% cap over time. This is shown in the figure below.

Figure 1.1: Projected performance against indicators assuming 2.5% rates cap

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Underlying result (1yr)	-22%	17%	-13%	-7%	-7%	-7%	-7%	-7%	-9%	-9%	-10%	-10%	-11%
Underlying result (4yr)	-13%	-7%	-2%	-5%	-1%	-8%	-7%	-7%	-7%	-8%	-9%	-9%	-10%
Liquidity	3.97	6.33	5.13	4.83	4.65	4.21	3.40	2.29	1.25	(0.08)	(1.37)	(2.95)	(4.53)
Self financing	32%	61%	36%	37%	27%	26%	21%	20%	19%	19%	18%	17%	17%
Indebtedness	4%	6%	2%	18%	17%	16%	16%	15%	14%	13%	12%	11%	11%
Capital replacement (1yr)	1.69	1.38	2.15	1.72	1.02	1.15	1.15	1.28	1.20	1.34	1.27	1.42	1.36
Capital replacement (4yr)	1.42	1.50	1.75	1.74	1.57	1.50	1.25	1.15	1.19	1.24	1.27	1.31	1.35
Accounting Renewal gap (1yr)	1.41	0.77	0.88	-	0.97	1.04	1.09	1.12	1.15	1.18	1.22	1.26	1.31
Accounting Renewal gap (4yr)	1.12	1.18	1.14	0.76	0.66	0.73	0.78	1.06	1.10	1.14	1.17	1.20	1.24

Source: Towing Shire Council application for a higher cap – The Statement, page 6, 2016

The council has also prepared projections showing forecast results for these indicators assuming ongoing rating increases of 6.34% per annum.

Figure 1.2: Projected performance against indicators assuming 2.5% rates cap

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Underlying result (1yr)	17%	-13%	-3%	-5%	-1%	0%	1%	2%	3%	4%	6%	7%
Underlying result (4yr)	-7%	-2%	-4%	0%	-5%	-2%	-1%	0%	1%	3%	4%	5%
Liquidity	6.33	4.93	5.16	5.04	5.09	4.74	4.27	3.99	3.59	3.40	3.12	3.35
Self financing	61%	36%	40%	28%	30%	25%	25%	26%	26%	27%	28%	28%
Indebtedness	6%	1%	16%	14%	12%	10%	9%	7%	5%	4%	2%	2%
Capital replacement (1yr)	1.38	2.15	1.58	0.97	1.10	1.10	1.24	1.16	1.30	1.23	1.38	1.32
Capital replacement (4yr)	1.50	1.75	1.71	1.52	1.44	1.18	1.10	1.15	1.20	1.23	1.27	1.31
Accounting Renewal gap (1yr)	0.77	0.88	-	0.97	1.04	1.10	1.13	1.16	1.19	1.23	1.28	1.32
Accounting Renewal gap (4yr)	1.18	1.14	0.76	0.66	0.73	0.79	1.06	1.11	1.15	1.18	1.22	1.26

Source: Towing Shire Council application for a higher cap – The Statement, page 6, 2016

Deloitte Access Economics has some reservations regarding the VAGO suite of 'financial sustainability risk indicators' and suggested target range outcomes as a basis for setting and judging a local government's financial strategy and performance. Nevertheless in Towong's case the projected indicator results do provide a clear picture of the scenarios faced and their implications.

1.3 Assessment of financial performance, position and outlook

Unlike the Local Government Performance Reporting Framework (LGPRF) 'adjusted underlying result' the VAGO 'underlying result' includes cash contributions from developers for capital projects in the calculation of both the numerator and denominator. Towong does not anticipate any revenue from such sources over the period of its current long-term financial plan. The VAGO and LGPRF indicators should therefore yield very similar 'underlying result' outcomes.

It is clear that Towong will not be able to operate in a sustainable way in future without significant additional revenue and/or cost reductions. Opportunities for additional revenue from sources other than rates (for example operating grants) are likely to be difficult to realise in the current climate. Given that Towong has already actively pursued and realised noteworthy savings initiatives it is reasonable to assume that further material operating cost reductions would be hard to realise without reductions in service levels.

If Towong fails to generate sufficient revenue to offset operating expenses on average over the long-term this will lead to a reduction in service levels regardless of whether the council plans for this or not. At some point in the not too distant future it would simply not be in a position to undertake major asset renewal and replacement as and when warranted.

It is important to note that the above projections suggest that Towong will need rate increases beyond the cap over several years. How many would depend on a range of factors. For example Towong's long-term financial plan currently assumes that the Commonwealth's 'Roads to Recovery' program will not be renewed after the current date of expiration of 2018-19. However, the program has previously been extended and this may possibly occur again. The program currently provides moneys equivalent to about 4% of total income in a 'normal' year.

It is also important to note that a council can usually maintain service levels in the short to medium term even with an operating deficit. Towong could for example operate without negative service level impacts in the near future if an increase beyond the rate cap was not approved for 2016-17.

Towong has low levels of debt. It could borrow more if liquidity became a problem but this would not be a long-term solution to the challenges the council faces. Ultimately income needs to be generated to offset service level costs. Borrowings are not income but they can help offset timing imbalances between outlays and income receipts. Strategic use of debt could be a small part of the solution over time if additional cash was needed (for example to carry out essential asset renewal outlays) but only if Towong was committed and able to address its adverse projected operating result over the medium term.

Towong is forecasting that it would have liquidity problems within about 7 years without an ongoing increase in rates beyond the cap. In reality it would be more likely that it would take other measures before this occurred, for example by reducing outlays on asset management.

Towong highlights the importance to its community of maintaining service levels from infrastructure assets. It has been undertaking asset management spending in the recent past at levels that it believes is appropriate to maintain service levels. Its long-term financial plan projections suggest that it is proposing to continue to do so in future. It is quite possible though that its future financial circumstances may dictate some reduction in future asset management outlays.

The relationship between service levels and long-run asset management costs and of outlay levels and their timing that minimises whole of life asset costs is not an exact science. Understandings and approaches in these regards in the local government environment are still evolving and improving. It is possible that in future Towong may be able to make some modest savings in the level of its asset management outlays without noticeable impact on service levels.

1.4 Concluding remarks

Towong could get by in 2016-17 without an increase in rates beyond the cap and without adverse impacts on service levels. It appears highly likely though that within the next few years it will need to either generate more income and/or make further savings that will impact somewhat negatively on service levels.

Towong has already made cost savings in a range of areas that are in excess of what is yet common elsewhere. Even if the sought after rate increase for 2016-17 was approved Towong would still need to seek further revenue increases in future if service level expenditure cutbacks were to be avoided. A future application for further rate increases beyond 2016-17 is therefore possible in due course.

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