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Assistance with review of 2018-19 rate cap application – City of Monash

Essential Services Commission

June 2018

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1.1 Project background

Following the release of the Essential Services Commission's (ESC's) final report in October 2015 on the introduction of a rates capping framework for local government, the Victorian Government established the Fair Go Rates System (FGRS). This arrangement limits the maximum amount councils may increase rates by in a year without seeking additional approvals. The rate cap set by the Minister for 2018/19 is 2.25% for all councils.

Under the FGRS, councils can apply to the ESC for a higher cap in circumstances where the rate cap is considered insufficient for their specific needs. The ESC has engaged Deloitte Access Economics to provide assistance with the review of the rate cap variation applications that are submitted by councils to apply for 2018/19 in order to inform the ESC's decisions. (Monash is the only such application this year.) Deloitte Access Economics undertook a similar process in the previous two years (for 2016/17 and 2017/18 applications) and previously provided advice to the ESC in the development of the rate capping framework.

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

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

The review has been conducted having regard to key factors highlighted and discussed in Deloitte Access Economics' 2016 Guidance Note, 'Assistance with review of 2016-17 rate cap variation applications', prepared for the ESC.

1.2 Overview

Monash is a large council located in the middle band of the south-eastern suburbs of Melbourne. It serves a population of about 190,000 residents and a land area of 81.5 km^2. Its submission and other supporting data suggests it is in a sound financial position and has strong financial management and general performance capabilities.

The Council has applied for a rate increase in 2018/19 of 1.28% above the specified 2.25% rate cap, that is an increase of 3.53%. The increase above the cap is expected to generate approximately $1,492,000 of additional rate revenue in 2018/19 and per annum thereafter (adjusted each year in line with the rate cap beyond 2018/19).

CoM is expecting to generate income of approximately $190.8 million (including from capital grants and assuming application of the 2.25% rate cap) in 2018/19. $120.2 million of this amount represents rates and service charges. Total income is boosted by capital related revenues of $4.7 million. Income net of this capital revenue would be $186.1 million.

Monash's expenses for 2018/19 are forecast to be $173.6 million. It forecasts an adjusted underlying result (surplus) for the year of 9.4%. (The adjusted underlying surplus (or deficit) ratio is calculated as the underlying result expressed as a percentage of underlying revenue. Adjusted underlying revenue is total income other than non-recurrent grants and contributions used to fund capital expenditure; and non-monetary asset contributions.)

The Council is seeking an increase in rates beyond the cap in order to negate the unexpected recent significant cost increases it has incurred for provision of its waste management services. There has been widespread media coverage recently of China's decision to curtail acceptance of materials collected through municipal recycling services. There are currently often very limited alternative markets for many such materials. Instead therefore of receiving a modest net income from recyclables collected, councils are now typically having to pay to dispose of them. Monash has recently agreed to pay its contractor $1.5 million per annum (plus annual CPI adjustment) over the next two years to accept such materials.

Most local governments in Melbourne separately apply an explicit waste charge to offset costs incurred in providing waste services. Monash has indicated that it is one of seven metropolitan municipalities that doesn't do so and instead recovers such costs through its general rates. The rate cap does not apply to waste charges where levied. Instead councils are allowed to set the charge to recover long-run actual costs incurred. If Monash had a waste charge in place it would be able to set it in 2018/19 at a level sufficient to offset higher expected costs.

1.3 Assessment of financial performance, position and outlook

All indications are that Monash is in a sound financial position and has the capacity to remain so in future with or without an increase in rates beyond the cap in 2018/19.

For reasons outlined in its '2016 Guidance Note', Deloitte Access Economics prefers to focus primarily on the trend adjusted underlying result in assessing the long-term financial sustainability of a council. Generally, Deloitte Access Economics considers that councils need to achieve at least a breakeven adjusted underlying operating result over time in order to maintain financial sustainability and service levels (including by having capacity to replace/renew assets when required).

It is apparent from Monash's submission and the supporting data it provides that it has well developed financial capabilities and conservative financial strategies. Data included highlights for example that its rates per assessment are at the lower end of the scale of Melbourne metropolitan councils. It also has no debt.

CoM has prepared 10-year long-term financial plan projections. (It appears that this document has been prepared specifically in support of its application for an increase in rates beyond the cap rather than as a public document.) Its forecast adjusted underlying results projected in that plan are shown in Table 1.1 below.

Table 1.1: Monash Projected Adjusted Underlying Result (AUR) with and without a higher increase in rates beyond the cap

Year	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024 -25
AUR (%) with higher cap	9.4	5.1	4.8	5.2	5.2	5.2	5.1
AUR (%) without higher cap	8.7	4.4	4.0	4.4	4.4	4.5	4.4

Table 1.1 shows that Monash's adjusted underlying operating result would deteriorate only slightly in future years without an increase in rates beyond the cap in 2018-19 and remain at a generally applicable satisfactory level based on current future forecast service levels and expenditure projections.

Monash's liquidity projections are shown below in Table 1.2. Whilst its liquidity would deteriorate slightly there is no suggestion that this deterioration would pose any specific challenges. (A typical benchmark for this indicator is 100%. A council with a healthy operating forecast could generally increase borrowings if necessary to improve liquidity.)

Table 1.2: Monash Projected Liquidity (as a % of current assets / current liabilities) with and without a higher increase in rates beyond the cap

Year	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024 -25
Liquidity (%) with higher cap	191	165	174	161	158	155	152
Liquidity (%) without higher cap	187	158	163	147	141	134	128

It is understandable that Monash is concerned at the potential loss of otherwise available cash as a result of the unexpected higher recycling costs. In reality though there doesn't appear to be any clear or sound reason why it needs higher liquidity than is projected without the higher cap at least in the next few years.

Monash claims that its current budget settings allow only modest expenditure on discretionary projects (total of $1 million of operational activity) and this capacity would be seriously impacted on if a higher cap was not approved. This however is a local financial strategy that could be relaxed. Presumably Monash has preferred to traditionally operate under relatively conservative financial strategy settings and constraints.

The Council perceives that it has been underspending on asset renewal. It is not clear as to the extent or robustness of CoM's asset management planning. It cites that it has been spending less on asset renewal in recent years than annual depreciation and would prefer to spend more. In our view annual depreciation expenses are not a reliable guide to optimal asset renewal outlays even over the medium-term (see '2016 Guidance Note'). There is no reason based on its current financial forecasts why it couldn't spend more on asset renewal if such was optimal. It has capacity to run down its existing cash on hand further and borrow considerably if need be.

It is unclear why Monash prefers to recover the cost of its waste services through its general rates rather than through a waste charge. Generally speaking public finance and cost recovery principles (including the Victorian Government's *Cost Recovery Guidelines*) would tend to favour recovery of the cost of such services through a waste charge (it would for example, promote greater transparency and allow better matching of costs with service provision). Monash claims that it would incur additional administrative costs from implementation of such a charge but these are likely to be minimal.

Monash has not consulted with its community regarding its decision to seek an increase in rates beyond the cap. The higher waste management costs were not anticipated and the Council felt it had to make an urgent decision to accept these arrangements. It has communicated with its ratepayers advising of its application for an increase beyond the cap and the reasons why it is seeking this increase. It believes there is a high level of community support for its current waste services.

Monash runs an annual 'best value' program (now 'Continuous Improvement Framework') aimed at generating savings of $500,000 per annum. Its application includes examples of various initiatives it has pursued in recent years that have realised savings and helped it maintain preferred services at modest rating levels.

1.4 Concluding remarks

Monash's financial projections suggest that it doesn't need an increase in rates beyond the rate cap at this time. It has the capacity to absorb the increase in its waste management costs for now without undercharging ratepayers for the services they are expected to receive and without placing any financial constraints on the Council in their provision.

If Monash's application is not approved it would effectively result in the Council having $1.5 million less in cash per annum cumulatively for each year that such a scenario existed. The Council's own forward financial projections suggest it can endure this scenario throughout the next 10 years. There is no evidence to suggest services would suffer if it didn't have this cash.

It is unclear what changes in waste management and recycling costs will incur in future. Monash's current contract arrangements are only for two years. It could reapply for an increase in rates beyond the cap in future if circumstances so warranted. Approving the increase (as sought) now would build an additional $1.5 million per annum (indexed by the future rate cap) into its revenue base in future.

If Monash found that it needed additional cash in future, for example to undertake an expanded capital works program in order to address perceived asset renewal needs it has considerable scope to borrow.

It could also consider introducing a waste management charge which would protect it from subsequent increases in waste costs beyond the cap.

An argument supporting a rate increase beyond the cap is that it would enable Monash to generate the additional revenue it would have been able to if it had had a waste charge and it should not be disadvantaged because it prefers not to have such a charge. A rate increase sufficient to offset the full additional cost over the next two years during that period would though build this additional revenue into its future annual base whereas cost impacts beyond the next two years are uncertain. It would be possible to grant a small additional increase now such that this increase and the consequential increase to its revenue base over time (e.g. say ten years) was equivalent (using discounted cash flow analysis) to expected additional recycling costs over the next two years.

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 2018-19 rate cap variation applications. You should not refer to or use our name or the advice for any other purpose.