



HORSHAM RURAL CITY 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).¹ 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 a council. This paper outlines our decision in response to an application by Horsham Rural City Council (Horsham or Council) for a higher cap of 3.5 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 matters² and the statutory objectives³ 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.

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

² Section 185E of the *Local Government Act*.

³ 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.⁴ 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 HORSHAM RURAL CITY COUNCIL'S APPLICATION

Horsham has applied for a higher cap of 3.5 per cent, that is, 1 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Horsham's application and decided to approve its higher cap of 3.5 per cent for 2016-17.

On balance, the Commission is satisfied, that based on current and forecast road asset service levels, a higher cap is appropriate for 2016-17 because Horsham does not otherwise have sufficient options to increase its road renewal expenditure for 2016-17.

However, the Commission considers Horsham 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 high priority.

⁴ Section 185E(6)(c) of the Local Government Act.

2. WHAT DID THE COUNCIL APPLY FOR AND WHY?

Horsham sought a higher cap of 3.5 per cent for 2016-17 (inclusive of the Minister's rate cap of 2.5 per cent). Horsham estimated that this would result in additional revenue of \$221 760 for 2016-17.⁵

Horsham will use the additional revenue in the coming years to narrow a growing gap between the renewal spending needed to maintain its existing assets — particularly roads and related infrastructure assets — and the funding available for that purpose.

A copy of Horsham's application including its response to our request for information (RFI) is available on the Commission's website. Appendix A shows the communications between the Commission and Horsham during the assessment period.

⁵ In response to our request for further information, Horsham confirmed that the correct value of the estimated additional revenue is \$221 760 (rounded to \$222 000) rather than the \$210 000 originally stated in its application cover sheet.

3. HOW DID WE REACH OUR DECISION?

Table 1 summarises the Commission’s observations of each of the relevant matters specified in Horsham’s 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. ^{a,b}
185E(3)(b) — reason(s) for which the council seeks the higher cap	<p>Horsham stated that the higher cap is to fund asset renewal. It noted the impact of the cumulative effect of a freeze on Federal Government grants and also the transfer of responsibility for certain expenditure to local government from the State Government.^{c,d}</p> <p>Road-related infrastructure accounts for 84 per cent of Horsham’s asset base, and the road Asset Management Plan refers to the need to increase its asset renewal expenditure.^{c,e} This plan draws on a consultant’s assessment, undertaken by Maloney Asset Management Systems (MAMS) most recently in June 2014. This assessment found that the condition of roads of all types had declined since the previous survey in January 2012.^f The MAMS consultant recommended:</p> <ul style="list-style-type: none"> increased asset renewal expenditure to prevent further deterioration that, if unchecked, will exceed industry-accepted standards and rise to dangerous and unacceptable levels;^g an affordable expenditure profile, starting with an increase of \$100 000 in year 1, increasing by 3 per cent annually, but warning of probable larger increases in renewal expenditure beyond year 10.^h <p>Horsham’s road Asset Management Plan states that the region’s difficult underlying soil structures allow movement and cracking of the roads, and so shorten their lives.ⁱ Council attributes the need for additional rate revenue above the Minister’s rate cap, both to its own policy of not borrowing for asset renewal,^j and to a limitation of the formulas that the Victoria Grants Commission uses to calculate the need for renewal in different areas of the State.^k</p> <p>Horsham also noted that renewal works are long overdue for many of its building assets (12 per cent of its asset base), but that it needs to undertake further work to quantify the increased expenditure needed to address its building asset renewal gap.^c</p>

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TABLE 1 (CONTINUED)

Legislative matter	Summary
185E(3)(c) — how the views of ratepayers and the community have been taken into account in proposing the higher cap	<p>Horsham’s application provided information and documents that appear to show that it engaged with its community in increasingly effective ways over time, about services, the asset renewal gap and the proposed higher cap.</p> <p>From 2008, Council has identified a portion of each year’s rate increase as a cumulative infrastructure levy ‘tagged’ for closing the asset renewal gap. The amount of this levy has been reduced to 1 per cent, reflecting affordability concerns in recent years.^k In 2015, Council identified the need to improve its methods of engagement, and sought community involvement for the purpose, achieving a 20-fold increase in participation.^{l, m} For the budget that year, Council held meetings with community groups or the general public at different venues, with more than 200 people participating and expressing views that were recorded for consideration.^m</p> <p>Council in 2015 participated in the LGV Community Satisfaction Survey, where its lowest score was for the condition of sealed local roads, but where only 27 per cent of respondents preferred a rate increase to a cut in (unspecified) services.ⁿ</p> <p>In early 2016, Council planned and carried out community engagement on the rate cap. The plan refers to using Council’s own website, and social and local media, to provide information and seek comments.^o Council held four meetings that attracted approximately 80 attendees.^j Material prepared for the meetings dealt with: the asset renewal gap and the need for increased spending on roads; and Council’s policy of not borrowing for existing assets, as a factor in seeking the 1 per cent cap variation. The presentation material also stated that Council would maintain service levels.^p</p> <p>In an online survey around the same time, 200 participants rated ‘Roads & Paths’ the most important council service. Asked if they would be willing to pay the requested higher cap to update ‘ageing roads and community facilities’, 37 per cent said ‘Yes’ and a further 22 per cent said ‘Maybe’. Around 90 free-form comments from the same survey were collected, analysed and summarised for the Horsham Councillors.^q</p> <p>A strength of Horsham’s community engagement has been its consistency with messages delivered over successive years, and the evident success of Council’s commitment to improving the reach of its engagement attempts. The plan for the recent engagement extends to considering the special needs of vision-impaired and young people in the community.^r</p> <p>The Commission noted that the level of engagement with ratepayers and other members of the community did not involve them in developing options as alternatives to the higher cap currently proposed.^s</p> <p>It is not clear to the Commission how Council weighed up the views it received from participants in the online survey. At the time of making the higher cap application, views expressed by members of the community at meetings or in other ways had been analysed but not yet presented to Council for consideration.^t</p>

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TABLE 1 (CONTINUED)

Legislative matter	Summary
185E(3)(d) — how the higher cap is an efficient use of council resources and represents value for money	<p>Council states that it continues to use resources efficiently by means of technology and workplace changes, while the rate cap drives economies in service delivery and operational expense.^u Horsham also lists a number of its Service Reviews, planned or completed as at November 2015. One such review was scheduled for roads in 2015-16 but had not been scoped by November 2015.^v</p> <p>Council’s Procurement Policy references the statutory <i>Best Value Principles</i> extensively, gives guidance on questions of probity, tendering and other processes, and stipulates a public tender process for purchases above a certain value (with three lower limits for competitive quotes).^w The Annual Report for 2014-15 refers to 60 competitive tenders valued at \$11.5 million.^x</p> <p>For expenditure on roads, the relevant Asset Management Plan deals with appropriate matters including Current and ‘Target’ Levels of Service, Risk assessment; and Routine Maintenance and Renewal/Replacement Plans. Horsham’s efforts to ensure value for money have had measurable success:</p> <ul style="list-style-type: none"> • the Know Your Council website shows that Horsham’s costs for local road reconstruction are around half those of other councils, and for local road resealing are two-thirds those of similar councils or one third those of all councils;^y • Local Government Victoria’s (LGV) Community Satisfaction Survey gives Horsham a score higher than the average for all councils (or all similar councils) for the performance measure ‘Decisions made in the interest of the community’.^z <p>Horsham said that, if more money is not spent now on the roads, they will deteriorate further and require ‘a massive injection of funds’ at a later stage.^{aa}</p> <p>Council has identified that its Asset Management Plan needs to fully quantify the community’s desired ‘target’ levels of service for road assets. Currently, ad-hoc feedback to councillors and staff, satisfaction surveys and other measures provide some indications of community expectations. But Council sees a need to consult on the actual costs of service, so that an informed community can participate in decision-making.^{bb}</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>At a high level, community feedback has prioritised the importance of different Council services, placing Roads & Paths highest. Council’s proposal to maintain expenditure on road renewal reflects its perceived overall importance to the community.^q</p> <p>Horsham’s Asset Management Plan outlines procedures for prioritising road renewal works, and new or upgrade projects. These procedures appear to take into account appropriate matters such as the current condition and expected life of existing assets, the impact on the community they serve, different technical approaches, etc.^{cc}</p> <p>Council stated that it considered alternative financing, including:^d</p> <ul style="list-style-type: none"> • periodic reviews of all non-statutory fees for service. • asset disposal through road closure cannot save significant expense. It is possible only where traffic is low and maintenance is therefore infrequent. • Horsham’s Loan Borrowings Policy explicitly excludes borrowing for expenditure on assets for recurrent capital works such as road resurfacing. • a full-time Grants Officer assists in obtaining funding. <p>To identify efficiencies and improvements in service delivery and ensure funds are targeted towards community priorities, Council stated that it conducts a program of Service Reviews. As at November 2015, the program included Waste Management, Accounts Receivable, Parks & Gardens, Maternal and Child Health, Immunisation and 11 other reviews at various stages of planning or completion (including Roads, referred to above).^v</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>Consultants Moloney Asset Management Systems (MAMS) have recommended a program of increased asset-renewal expenditure. The report is based on records of capital expenditure to date, assessment of changes in the condition of the assets, and prediction of their remaining useful life.</p> <p>The Roads Asset Management Plan incorporates the expenditure model from the MAMS. It concludes with a 10-year forecast for renewal expenditure which, increasing at 2.9 per cent annually, closely matches the MAMS recommended annual increase of 3 per cent.^{e, dd}</p> <p>Qualitative assumptions in the proposal relate to increased traffic on urban roads, larger and heavier agricultural vehicles and trucks, etc.^{bb}</p> <p>Council has shown that its proposal is consistent with a longstanding program to maintain and renew its road assets, which has involved commissioning five technical assessments of their condition, expected life and renewal requirements from 2002-14.^{ee}</p> <p>Council advises that it has yet to complete a Long-term Financial Plan (LTFP).^{ff} However, its Budget Development Guidelines for 2016-17, include a key objective of facilitating the development of the plan.^{gg}</p>

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TABLE 1 (CONTINUED)

Legislative matter	Summary
185E(3)(f) (continued)	<p>The Commission has found it difficult to reconcile the amount of the additional revenue sought by Council, with the MAMS report. The Commission noted that Council does not appear to have a schedule that would allow matching of expenditure recommended by MAMS, by asset class (Roads, Bridges, etc) and purpose (New, Renewal or Upgrade) over time, to the expenditure proposed.</p> <p>However, its higher cap proposal is supported by the Council Plan 2016-20 and Strategic Resource Plan (SRP), as follows:^{hh}</p> <ul style="list-style-type: none"> • When published, the SRP proposed an annual rate increase of 4.5 per cent, including 2.0 per cent for infrastructure renewal (but not demand growth) — now replaced by a proposed 3.5 per cent increase that includes 1 per cent for renewal. • The SRP shows asset renewal expenditure increasing from \$7.37 million to \$10.78 million from 2016-17 to 2018-19.

^a Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 1. ^b Budget Baseline Information, 'Calculating the higher cap' sheet. ^c Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 5. ^d Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 16. ^e Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Asset Management Plan Part B — Roads"*, March, p. 61. ^f Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Moloney Asset Management Systems Report"*, March, p. 5. ^g Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Moloney Asset Management Systems Report"*, March, p. 7. ^h Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Moloney Asset Management Systems Report"*, March, p. 4. ⁱ Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Asset Management Plan Part B — Roads"*, March, p. 30. ^j Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 11. ^k Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 3. ^l Horsham Rural City Council 2016, *Response to Request for Information*, April, p. 2. ^m Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 10. ⁿ Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Community Satisfaction Survey"*, March, pp. 8, 32. ^o Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Report to Council on Community Engagement 16-17"*, March, pp. 2. ^p Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Example of 2016-17 Budget Presentation"*, March, pp. 6-9. ^q Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Online Budget Survey 2016-17 Report to council"*, March, pp. 2-5. ^r Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Report to Council on Community Engagement 16-17"*, March, pp. 12-13. ^s Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Report to Council on Community Engagement 16-17"*, March, p. 7. ^t Horsham Rural City Council 2016, *Response to Request for Information*, April, pp. 3-4. ^u Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 14. ^v Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Current Service Reviews List"*, March, p. 1. ^w Procurement Policy May 2015 (Downloaded 13 April 2016), s. 6 & p. 11. ^x Horsham Rural City Council 2016, *Higher Cap Application — Attachment "HRCC Annual Report 2014-15"*, March, p. 60. ^y Know Your Council Performance Summary 2014-2015 — (Downloaded 2 May 2016), p. 8. ^z Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Community Satisfaction Survey"*, March, pp. 13. ^{aa} Horsham Rural City Council 2016, *Higher Cap Application*, March, p. 15. ^{bb} Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Asset Management Plan Part B — Roads"*, March, pp. 20-21. ^{cc} Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Asset Management Plan Part B — Roads"*, March, p. 42. ^{dd} Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Asset Management Plan Part B — Roads"*, March, p. 65. ^{ee} Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Asset Management Plan Part B — Roads"*, March, p. 33. ^{ff} Horsham Rural City Council 2016, *Response to Request for Information*, April, p. 7. ^{gg} Horsham Rural City Council 2016, *Higher Cap Application — Attachment "HRCC Budget development Guidelines 16-17"*, March, p. 13. ^{hh} Horsham Rural City Council 2016, *Higher Cap Application — Attachment "Council Plan 2016-2020"*, March, pp. 34, 38.

3.1 ASSESSMENT

As required under the FGRS, we have examined each of the six legislative matters addressed in Horsham's 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, we make the following findings:

- Horsham's financial capacity is constrained and it has limited flexibility
- Horsham has identified its road network renewal needs based on current and forecast road asset service levels
- Horsham has consulted with its community on service priorities which suggest some support for higher rates to fund ongoing investment in road renewal.

In its application for a higher cap Council noted that its Asset Management Plan (AMP) still needs to better reflect the community's desired levels of service for its road assets. Therefore, it is not clear to the Commission how the community would prioritise expenditure across the Council's road network in light of Council's financial constraints (ie whether community expectations align with the council's technical assessment). Such a strategic assessment will be necessary to inform Council's expenditure on its road infrastructure and any future application for a higher cap. Horsham is yet to fully develop its long-term financial plan which would more clearly reflect its community's preferences.

On balance, we considered that Horsham's road renewal needs remain in 2016-17 despite the absence of a more strategic and affordability driven assessment of its infrastructure needs. On this basis, we support the higher cap to apply in 2016-17 with the qualification that Horsham should undertake a more strategic infrastructure need assessment and integrate that into its long-term financial planning as a matter of high priority.

The assessment of the underlying asset renewal need is discussed below.

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 Horsham’s financial position. Horsham also provided forecasts of the impacts on its Local Government Performance Reporting Framework (LGPRF) financial indicators (under both ‘with’ and ‘without’ higher cap scenarios). They show that Horsham operates with a modest negative adjusted underlying result in the short- and medium-term (table 2).

The forecasts also show its asset renewal ratio will be higher in the ‘with’ higher cap scenario, consistent with its proposal to use the revenue from the higher cap to fund asset renewal (table 2).

TABLE 2 LOCAL GOVERNMENT PERFORMANCE REPORTING FRAMEWORK INDICATORS

LGPRF indicator ^a	2014-15 (Actual)	2015-16 (Budget)	2016-17 (Forecast)	2017-18 (Forecast)	2018-19 (Forecast)
Operating position^b					
Adjusted underlying result (%)					
pre-FGRS	6	-12.3			
‘without’ higher cap (a)			-3.3	-6.2	-5.9
‘with’ higher cap (b)			-2.8	-5.7	-5.4
difference (b-a)			0.5	0.5	0.5
Obligations^b					
Asset renewal (%)					
pre-FGRS	92	100.5			
‘without’ higher cap (a)			93.1	65.9	69.9
‘with’ higher cap (b)			95.1	67.9	71.9
difference (b-a)			2.0	2.0	2.0

Note: Under the Local Government Performance Reporting Framework (LGPRF), councils are required to report annually on their performance against a number of financial and output measures. ^a Table only includes LGPRF indicators considered in making our decision. ^b See Appendix B for definitions of these indicators.

Source: Horsham Rural City Council 2016, *Response to Request for further information*, April.

Since 2008, Council has identified a portion of each year's rate increase as an infrastructure levy 'tagged' for closing the asset renewal gap. In recent years, this levy has been reduced to 1 percentage point, in recognition of affordability concerns. This is consistent with the higher cap being sought by Horsham for 2016-17.

Horsham's proposal to increase its road asset renewal is supported by its AMP. The AMP draws heavily on independent assessments of road condition by Moloney Asset Management Systems (MAMS) (most recently in June 2014). This MAMS assessment found that the condition of roads of all types has declined since the previous survey and recommended increased asset renewal expenditure to prevent further deterioration.

However, we note that Horsham has yet to reflect the community's desired target levels of service for road assets in its AMP. Aligning its technical assessment of road renewal need with its communities' expectations should be done as part of a strategic review of its renewal needs.

Horsham's financial capacity is constrained and Council has limited overall flexibility to manage its current road renewal need, such that a rejection of the proposed higher cap could result in even higher caps to be sought in the future or likely deterioration of services and infrastructure.

MONITORING OF OUTCOMES

Under the FGRS framework, we are required to report annually on Horsham's compliance with its rate cap and every two years on outcomes from the FGRS. When doing so, we will monitor and report on whether Horsham 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 the community and ratepayers receive confirmation that Horsham 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 Horsham's explanation for the reallocation of those funds.

APPENDIX A: SUMMARY OF COMMUNICATIONS WITH HORSHAM

Horsham submitted its application for a higher cap on 31 March 2016. In response to its application the Commission sought additional information from Horsham (table 3). Horsham's application and its response to our request for further information can be found on our website.

TABLE 3 COMMUNICATIONS BETWEEN HORSHAM AND THE COMMISSION

Date	Nature of communication
31 March	Horsham submitted its application
18 April	Commission issued to Horsham a request for information (RFI)
29 April	Horsham submitted its response to the RFI
5 May	Commission sent follow-up questions related to Horsham's calculation of the higher cap
6 May	Horsham responded to questions related to Horsham's calculation
11 May	Commission sent further questions related to Horsham's calculation of the higher cap Horsham responded to the Commission's queries.

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 suggests greater 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.