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Assistance with review of 2017-18 rate cap applications – Borough of Queenscliffe

Essential Services Commission

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1 Borough of Queenscliffe

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 2017/18 is 2.0% 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 2017/18 in order to inform the ESC's decisions. Deloitte Access Economics undertook a similar process last year (for 2016/17 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 Borough of Queenscliffe (BoQ) 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.

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

Queenscliffe is a very small council located at the eastern tip of the Bellarine Peninsula adjacent to the City of Greater Geelong to its west. It is approximately 105 kilometres south-west of Melbourne. It serves a population of about 3,000 people and a land area of only 8.6 km^2. BoQ suffers similar challenges to other small rural councils in terms of lack of economies of scale but its small land area and proximity to Melbourne and Geelong means it is better placed to attract and retain staff and contractors and have less infrastructure maintenance and renewal challenges.

The Council has applied for a rate increase in 2017/18 of 2.5% above the specified 2.0% rate cap, that is an increase of 4.5%. The increase above the cap is expected to generate approximately $150,000 of additional rate revenue in 2017/18 and thereafter (adjusted each year in line with the rate cap beyond 2017/18).

BoQ is expecting to generate income of approximately $13.1 million (including from capital grants and assuming application of a 4.5% rate increase) in 2017/18. $7.1 million of this amount represents rates and service charges. Total income is boosted by capital related revenues of $2.8 million. Income net of this capital revenue would be $10.3 million.

Queenscliffe's expenses for 2017/18 are forecast to be $10.9 million. It forecasts an adjusted underlying result (deficit) for the year of -4.7%. (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 has identified $103,500 worth of works (capital and operating) that it proposes not to proceed with in 2017/18 if its application for an increase is not approved. It had already reduced proposed asset renewal expenditure for both 2017/18 and 2018/19 in order to address other perceived priorities.

BoQ has a relatively small stock of infrastructure assets. Depreciation in 2016/17 is forecast to be $1.1 million or only 11% of total operating expenses. As a result, costs associated with ongoing asset management (asset maintenance and renewal) are likely to be less of a financial challenge for it (at least on average over time) compared with small rural councils with large land areas (that typically have much higher annual depreciation relatively to operating income).

1.3 Assessment of financial performance, position and outlook

For reasons outlined in its '2016 Guidance Note', Deloitte Access Economics prefers to focus 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 as required).

It appears that Queenscliffe is still at a relatively early stage in having appropriate regard to long-run financial sustainability considerations in its financial decision-making. It recognises that it faces financial challenges and believes that it can't maintain current services and deliver on the draft Council Plan 2017-2021 without rate increases beyond the cap.

At the same time, it doesn't yet have a 10-year long-term financial plan. It does have four year forward financial projections prepared as part of development of its 2017/18 Draft Budget and has recently developed a 5-year financial plan. Its recent and forward projected adjusted underlying result is shown below in Table 1.1.

Table 1.1: Queenscliffe Actual & Projected Adjusted Underlying Result (as % of projected total revenue) if 4.5% rate increase approved for 2017/18

Year	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Adjusted underlying result (%)	-1.9%	-2.4	-4.7%	-7.2%	-2.4%	-1.2%	0.8%

BoQ argues that the more adverse forecast results above for 2017/18 and 2018/19 are essential timing related issues. Nevertheless Table 1.1 does show an annual average adjusted underlying operating result of -2.9% (i.e. deficit). This is not a large deficit but over time will mean it becomes ever more difficult to maintain service levels and cash holdings are likely to fall (without further borrowings). The current forecast is that the deficit will be very modest by 2020/21 and a small surplus (effectively break-even result) will be achieved in 2021/22. Even if such improvements were realised BoQ is likely to incur ongoing challenges.

If rates were kept to the cap in 2017/18 (and beyond) this would have the effect of reducing the forecast adjusted underlying result by about 1.3% per annum in that year and thereafter.

It is likely therefore that even with the rate increase proposed BoQ will need to generate more revenue or reduce costs further over the medium term.

It was noted in Section 1.2 that asset management is likely to be a less significant financial sustainability factor for Queenscliffe because of its small geographical area than is often the case for other (particularly rural) councils. BoQ claims that it has prepared asset management plans but also notes in its application that it is unable to fully fund asset renewal requirements identified in the asset management plans. This is not surprising given its adjusted underlying deficit. If BoQ is unable to incur outlays in future approximately consistent with its asset management plan identified needs it is likely that assets will prematurely fail with negative implications for risk, whole of life costs (as a result of shorter resulting asset lives) and service levels.

Queenscliffe recognises that its scale means that it has diseconomies of scale relative to other councils and gives examples of collaborative initiatives it is pursuing or has pursued to counter-act this. It has not included as much detail as some other rate cap increase applicant councils as regards steps taken to reduce costs and improve efficiency to date. It plans to borrow money in 2017/18 to finance conversion of its streetlighting to LED lighting which is expected to deliver ongoing savings. The reality is it will in all likelihood need to find more means to improve efficiency (and therefore reduce operating costs) in future and/or rationalise assets (which may have service level implications) if it is to avoid applying for further rate increases in future to improve financial performance. Like all councils that are on the financial margin it has particularly felt the impact of reduced ongoing funding from other spheres of government in recent years.

Queenscliffe highlights that it has been successful in receiving one-off grants to assist in funding new capital works in recent times. It is understandable that a council would seek such funding but it is very important that they have regard to the financial sustainability implications of such proposals. New capital works for example typically will result in higher long-run (depreciation and other) operating costs and add to future service level and financial sustainability challenges. It is important therefore that councils commit to financial sustainability and have well-developed long-term financial plans that enable them to model and assess the impact and implications of various financial options.

It appears that BoQ decided at a relatively late stage to apply for a rate increase in excess of the cap for 2017/18. It has been consulting its community in connection with its draft budget and the proposed rate increase beyond the cap but community feedback is not clear at this time.

Queenscliffe has and currently proposes to maintain modest levels of borrowings. It expects to raise additional borrowings in 2017/18 and beyond to fund capital works. Debt is expected to rise from $0.1 million in June 2017 to $0.7 million in June 2020. Queenscliffe's application appears to have been generated at least in part as a result of concerns in the run-down of cash (primarily arising as a result of the period of redevelopment of its tourist parks). If it can improve its long-run operating result it could borrow more if need be to address perceived cash-flow needs, for example large asset renewal needs if they arise.

1.4 Concluding remarks

It is not clear that it is essential that BoQ receive approval for the rate increase it has sought for 2017/18. It is likely that it could maintain service levels in the short-run with an increase of no more than the cap.

It is also possible that it could commit to works it has identified as not to proceed without the rate increase beyond the cap in 2017/18.

A rate increase beyond the cap at some stage in the next few years may well be justified but there is not sufficient evidence to confirm this now. Council should first focus on developing a robust (10-year) long-term financial plan and consult with its community regarding service level and rate increase impact options. Such a plan should be underpinned by strategies based on achieving and maintaining ongoing financial sustainability that adequately accommodates all necessary asset management needs and realises efficiency improvements wherever possible. This may require it to critically review service levels to determine the long-term balance that its community desires and is willing to pay for.

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 2017-18 rate cap variation applications. You should not refer to or use our name or the advice for any other purpose.