Deloitte.
Access Economics

Assistance with review of 2017-18 rate cap applications – West Wimmera Shire Council

Essential Services Commission

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1 West Wimmera Shire Council

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 West Wimmera Shire Council 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

West Wimmera Shire Council is a small rural council located in the western part of Victoria. It serves a relatively small population (about 3,855 people) and relatively large land area (9,108 km^2). It has a relative socio-economic disadvantage index score of 5.0, slightly worse than the state-wide average of 5.47.

Deloitte Access Economics considers that councils like West Wimmera Shire that serve small resident populations and relatively large land areas typically face above average financial sustainability challenges. Local governments are very asset-intensive (predominantly for example road infrastructure) and a lower population density means a smaller ratepayer base to spread large long-run infrastructure asset costs across.

The Victorian Auditor General's Office explicitly highlighted the additional financial sustainability challenges of rural councils in its recent 'Local Government 2015-16 Audit Snapshot' report (see e.g. pp. vii and ix).

West Wimmera Shire Council has applied for a rate increase in 2017-18 of 1.5% above the specified 2.0% rate cap, that is an increase of 3.5%. It has also applied for a rate increase of 3.5% for the following three years (2018-19 – 2020-21) and effectively has assumed that the rate increase in those years will be below 3.5%. The increase above the cap is expected to generate approximately $98,000 of additional rate revenue in 2017-18 and cumulatively approximately $1 million over the next 4 years (assuming a rate cap of 2% is in place each year).

West Wimmera is expecting to generate income of approximately $29.3 million (including from capital grants and assuming application of a 2.0% rate cap) in 2017-18. Only $7.9 million of this amount represents rates and service charges. Total income is boosted by large one-off capital related revenues of $8.1 million. Income net of this capital revenue would be $21.2 million.

The Shire's expenses for 2017-18 are forecast to be $22.7 million. It forecasts an adjusted underlying deficit for the year of -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.)

West Wimmera has a large stock of infrastructure assets (overwhelmingly roads), and depreciation in 2016-17 is forecast to be $6.8 million or 31% of total operating expenses. This is a very large figure and represents the estimated rate of asset consumption incurred in service provision. The Council recognises that its assets are depreciating at a rate in excess of its capacity to renew them.

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 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).

Table 1.1 below shows West Wimmera's projected adjusted underlying result (sourced from the Excel spreadsheet of data supplied by West Wimmera to ESC). It assumes a 3.5% increase in rates throughout the ten-year period (i.e. higher than the 2017-18 cap and higher than the possible cap in subsequent years).

Table 1.1: West Wimmera Projected Adjusted Underlying Result (as % of projected total revenue) if rate increase approved and maintained thereafter

Year	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
Net result (%)	-6.5%	-17.6%	-14.8%	-15.6%	-16.2%	-15.9%	-16.0%	-16.1%	-16.7%	-16.7%

West Wimmera considers that the rate increase sought will generate sufficient income to fund the level of asset renewal expenditure required in the next few years and maintain other warranted service levels. The projections in Table 1.1 suggest that even with the proposed rate increases above the cap, West Wimmera is still likely to have significant ongoing financial challenges in the medium to longer term.

The most likely consequence of an ongoing deficit is that a council is not generating sufficient income to accommodate the renewal or replacement of assets when cost-effectively optimal to do so to maintain service levels. As a result, assets typically are necessarily held for longer periods of time with adverse consequences for service levels and possibly higher risk of failure.

Information provided by West Wimmera as part of its submission suggests that it recognises its financial challenges but also suggest that it is still at a relatively early stage in embracing asset management and long-term financial planning in assessing options and their implications. Its (possibly draft) Asset Management Strategy (Feb 2017) for example is still relatively new and doesn't quantify specified asset service levels or variation in forecast expenditure needs from varying service levels. It appears also that financial decisions seem to focus more on levels of cash needed for particular expenditure outcomes rather than to eliminate the operating deficit.

For example, West Wimmera indicates that a key consideration in seeking the rate increase is to generate sufficient cash to enable asset renewal outlays to closely match annual depreciation over the next few years. Deloitte Access Economics' view is that it should not be assumed that asset renewal expenditure of the order of about 100% of the level of annual depreciation should necessarily be aimed for in any period (or even over the medium term).

Asset renewal needs can be lumpy between periods (particularly for longer-lived assets but less so for those with shorter lives such as unsealed roads) and affordable service level preferences can change. Nevertheless, given West Wimmera's projected operating circumstances, it is highly likely that it will necessarily be underfunding asset renewal over the next decade relative to what is cost-effective to do to maintain existing asset service levels. The Council highlights for example in its Asset Management Strategy that it estimates it has an estimated annual asset expenditure renewal gap of $2.8 million per annum over the next 10 years (based on renewal forecasts compared with depreciation) (see pp 19-20). The impact of its proposed rate increase on that projection is unclear but could possibly marginally offset this gap. The document also highlights a range of initiatives the Council could pursue to improve its strategic asset management planning processes (see pp 11-12).

West Wimmera Shire has highlighted in its submission that without additional spending, Council's road asset conditions will become progressively worse, with an estimated 79.8% rated as being in average or worse condition by 2025, compared to 21.6% being rated this currently. It believes this impending degrading of the condition of its road network has the potential to significantly affect freight across the municipality, hindering growth.

It has also indicated that all additional rate income generated by the proposed 3.5% rate increase will be channelled into capital spending to arrest the decline in the condition of Council's asset network. It has also recently initiated a review of its building assets and road networks with the aim of identifying low priority needs and reducing renewal expenditure for those assets.

West Wimmera Shire recognises that the proposed 4-year rate increase will not on its own solve all of Council's problems. It claims though that it will halt a further decline. This assessment is presumably based on its shortterm identified asset renewal needs. Its predicted ongoing operating deficit even with the rate increase suggests further decline will occur over this period.

In its submission, West Wimmera highlights that it has traditionally had modest, below average rating levels. It is understandable that it has strived to keep rates as low as possible but it also potentially confirms that the Council hasn't had enough regard to the longer-term in its rates, expenditure and service level decision-making. In fairness, West Wimmera argues that it has been adversely affected by real-term reductions in available grant funding programs from other levels of government in recent years. This is undoubtedly true and highlights the vulnerability of rural councils in particular, which have often traditionally had a high proportion of grants in their total income.

West Wimmera has recognised the need to turn things around although it is likely that more hard work and difficult choices lie ahead. The council highlights evidence of savings it has made and efficiencies it has pursued but more will need to be done (or rates will need to rise further in future) if the council is to eliminate its operating deficit and therefore be able to maintain service levels thereafter. It believes that there is very little room to further cut expenditure without a reduction in services.

The council has consulted with its community regarding its financial circumstances and the options it faces and their implications. It has indicated that some residents have advised that they are keen for rate increases to be kept as low as possible but many also don't want to see service levels fall.

West Wimmera Shire currently has very modest levels of debt ($0.3 million at end 2016-17). It recognises that its financial circumstances are such that it needs to focus on improving financial sustainability and that additional debt is unlikely to assist in this regard. It does have (unquantified) financial assets (reserves) that it claims it could potentially utilise (e.g. to meet asset renewal needs in the short-run) but acknowledges these would be depleted within 10 years (or possibly sooner) if it doesn't address its financial sustainability challenges.

1.4 Concluding remarks

It appears that West Wimmera is still at a relatively early stage in applying long-term financial planning and asset management planning to weigh up options to best determine how to achieve ongoing financial sustainability and their associated implications. The rate increases it has sought for the next four years will help but current estimates suggest further rate increases thereafter or additional expenditure and service level reductions will be necessary unless ongoing grant levels increase.

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.