Deloitte Access Economics

Assistance with review of 2016-17 rate cap variation applications

City of Casey

Essential Services Commission

May 2016

Deloitte.

Contents

1 City of Casey

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 City of Casey 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

Casey is a very large outer metropolitan council with approximately 288,500 residents. Of particular relevance for the purposes of this report is that it forecasts significant and sustained ongoing population and housing growth. It is estimated to have a population of 459,000 residents by 2036. This represents an average annual increase in population of about 2% per annum over this period.

There will no doubt be fluctuations in the above rate of growth in Casey between periods over this 20-year horizon and indeed some possible variation in the aggregate growth rate over the full period for a range of reasons. This should not give rise to undue concern.

---

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

Bearing in mind Casey's locational advantages and the population projections for the Melbourne metropolitan area, Casey can be confident of significant ongoing growth and should plan accordingly.

Casey is seeking an increase of 0.97% above the rate cap for 2016-17. If approved this would increase its revenue by $1.6 million in 2016-17 and build that amount into its annual rate revenue base thereafter. It argues it needs this increase in order to maintain working capital and financial asset levels sufficient to offset its future expected capital expenditure and other outlays. It has provided financial forecasts based on strategies and assumptions that support these claims.

1.3 Assessment of financial performance, position and outlook

In 2014-15 Casey generated income of $352 million, including $178 million from rates and charges and $86 million for grants and contributions associated with capital expenditure projects and programs. Its expenses were $241 million and it therefore generated a surplus of $111 million or $25 million net of capital expenditure related revenues. (Note this result was higher than what the underlying result would have been because the Commonwealth paid Financial Assistance Grants to councils in 2014-15 that normally would not have been paid until 2015-16.)

As at end June 2015 Casey controlled assets with a value of $2.3 billion; the majority of which were land, buildings and infrastructure worth $2.1 billion. Its total liabilities were $121 million. It had negative net financial liabilities (total liabilities less financial assets) of $112 million.

Casey is currently generating a relatively high adjusted underlying operating surplus ratio.[2] The Victorian Local Government Performance Reporting Framework (LGPRF) requires publication of local governments' past and projected results for various financial indicators. The adjusted underlying result ratio is by far the most critical indicator of a council's performance. Casey's projected performance for this indicator based on its preferred rating increases, (including increase beyond the cap in future years), is shown below.

Table 1.1: LGPRF indicator - Adjusted underlying result ratio

	2015-16	2016-17	2017-18	2018-19
Adjusted underlying result ratio	18.0%	12.3%	11.2%	11.4%

[2] Adjusted underlying surplus (or deficit) (adjusted underlying surplus (or deficit) as a percentage of underlying revenue). Adjusted underlying revenue means total income other than—

(a) non-recurrent grants used to fund capital expenditure; and

(b) non-monetary asset contributions; and

(c) contributions to fund capital expenditure from sources other than those referred to in paragraphs (a) and (b).

Casey's long-term financial plan (based on its current preferred level of rate increases and expenditure outlays) projects strong on-going adjusted underlying operating surpluses throughout the next 10 years.

If a council can maintain a positive adjusted underlying operating result it suggests that sufficient revenue is being generated (including in part from ratepayers and service recipients) to offset the cost of service provision. A small surplus may be reasonable for risk and uncertainty and to generate cashflow to help with financing capital works. A high ongoing surplus can indicate that a council is over-charging current ratepayers relative to the cost of the services it provides.

What level of surplus is reasonable or excessive will depend on a council's current and expected future operating environment and expenditure needs. Intergenerational equity considerations and regard to the relatively stable and predictable nature of local governments' revenues and the long-lived infrastructure-intensive nature of local government service provision are factors that weigh against the need generally for local governments to strive for large ongoing operating surpluses. Arguably Casey's projected underlying adjusted operating surplus with its preferred rating strategy is at the higher end of what may be reasonable.

Casey has indicated that it would not proceed with the projects if the sought rate increase above the cap was not granted. The ESC requested that Casey provide financial projections based on limiting rate increases to the cap but with its expenditure proposals unchanged. Those projections showed that Casey could maintain a comfortable adjusted underlying operating surplus ratio over the next 3 years as shown below.

Table 1.2: LGPRF indicator - Adjusted underlying result ratio

	2015-16	2016-17	2017-18	2018-19
Adjusted underlying result ratio	18.0	11.8	9.7	9.1

Casey's perceived need for an increase in rate revenue in excess of the rate cap in order to accommodate proposed 2016-17 and estimated future outlays arises for two prime reasons:

1. It is intending to make far less use of debt over the planning horizon than we would consider to be warranted in its circumstances.
2. It has a policy position of retaining monies in 'working capital' and financial assets in excess of what is necessary or warranted.

Casey has negative net financial liabilities. That is, it has more financial assets than total liabilities and is projecting (based on its preferred revenue projections) that this remain so over the next 9 years. At the same time it is proposing to outlay $1.0 billion (in nominal values) on capital expenditure over the next 10 years. Only approximately $234 million of this amount is forecast to be funded by grants and contributions from developers and other spheres of government and $55 million from new borrowings (net of repayment of existing borrowings).

In short, the council is proposing to very heavily rely on generating additional revenue from ratepayers over the next 10 years to finance the bulk of its capital works program. These capital works will provide service benefits to ratepayers well beyond this period. As such, Casey should consider financing a much larger share of future capital expenditure from borrowings (and running down its stock of financial assets) and keeping future rate rating increases lower.

Casey appears to have a policy position of fully 'cash backing' provisions for future liabilities (e.g. employee leave entitlements) and those equity reserves that it has established to recognise future possible expenditure needs. This is a traditional conservative approach that was once encouraged but is not necessarily in the best long-term interests of a council or its residents and especially those with high growth and capital expenditure outlay needs.

A better approach would be for the council to focus on managing its finances on a more holistic basis. This is currently widely promoted in all states following the application of accrual accounting and long-term financial planning in local government. Casey claims that its budget would not 'balance' if it were to undertake the specified projects without the sought after rate increase. However, this is only because of its own policies regarding the level of working capital and financial assets it holds. It claims that an 'unbalanced budget' would ultimately result in future cashflow shortfalls. This would arise though only because of 'cash backing' reserves and its reluctance to use greater levels of debt and the relatively short-term period over which it plans to repay any debt raised.

Casey's policies regarding the extent of use of debt, how and when it borrows and treasury management warrant review, particularly having regard to its future projected growth and capital expenditure forecasts. For example it is proposing to borrow $85 million for major capital projects over next two years whilst also holding far more than that in financial assets. Rather than borrow externally it would reduce net interest costs (by possibly $1.5 million or more per annum) and its interest rate risk exposure by utilising its financial assets to avoid (or at least delay) the need to borrow.

It is possible that in the medium-term to longer-term Casey may be justified in seeking and having a rate increase beyond the cap approved to help maintain a healthy operating surplus result and not have to rely excessively on borrowings to finance capital expenditure needs. For the next few years at least though, it appears to be able to accommodate outlay needs and charge ratepayers fairly from an intergenerational perspective without an increase beyond the rate cap.

1.4 Concluding remarks

It is noted that Victorian councils have significant regard in determining their financial strategies to the 'financial sustainability risk indicators' and target range outcomes suggested and reported by the Victorian Auditor General's Office. It is not believed that those indicators and targets should necessarily be the prime consideration by each council in all circumstances in their financial decision-making. Even so, Casey is likely to be able to maintain satisfactory performance against such targets in the next few years without a rate increase in excess of the cap.

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

Deloitte Access Economics is Australia's pre-eminent economics advisory practice and a member of Deloitte's global economics group. For more information, please visit our website www.deloitteaccesseconomics.com.au

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 200,000 professionals are committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms. Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 6,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.