

Assistance with
review of 2016-17
rate cap variation
applications

Rural City of
Horsham

Essential Services
Commission

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1 Rural City of Horsham

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 Rural City of Horsham 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

Horsham Rural City Council is a large rural municipality. It has a population of about 20,000 and is expected to experience modest population growth averaging between 0.5% and 1% per annum over the next decade. It has applied for a rate increase of 1.0% above the 2.5% rate cap and this would generate additional revenue of about \$210,000 in 2016-17.

It states that it is seeking the additional increase in order to enable it to spend more on asset renewal. In 2014 it commissioned a report from an asset management consultant who condition-assessed the council's road network and recommended that it increase

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

expenditure on road asset renewal by 3% per annum (assumed to be in real rather than nominal terms) each year over the following 10-year period.

If Horsham's application is unsuccessful it proposes to spend \$210,000 less in 2016-17 on asset renewal outlays and leave other expenditure unchanged.

1.3 Assessment of financial performance, position and outlook

Horsham budgeted for approximately \$47.5 million in income in 2015-16, including \$6.5 million in capital related grants and contributions. Budgeted rates and charges were \$23.5 million.

Horsham's budgeted expenses for 2015/16 are \$45.7 million. It effectively has budgeted for a modest adjusted underlying operating deficit. In its 2015-16 budget it reported the results and projections below for its adjusted underlying result ratio (based on an assumed rate increase of 3.5% pa).

Table 1.1: Adjusted underlying result ratio

	2014-15	2015-16	2016-17	2017-18	2018-19
Adjusted underlying result ratio	-4.7%	-4.2%	-4.9%	-2.6%	-0.3%

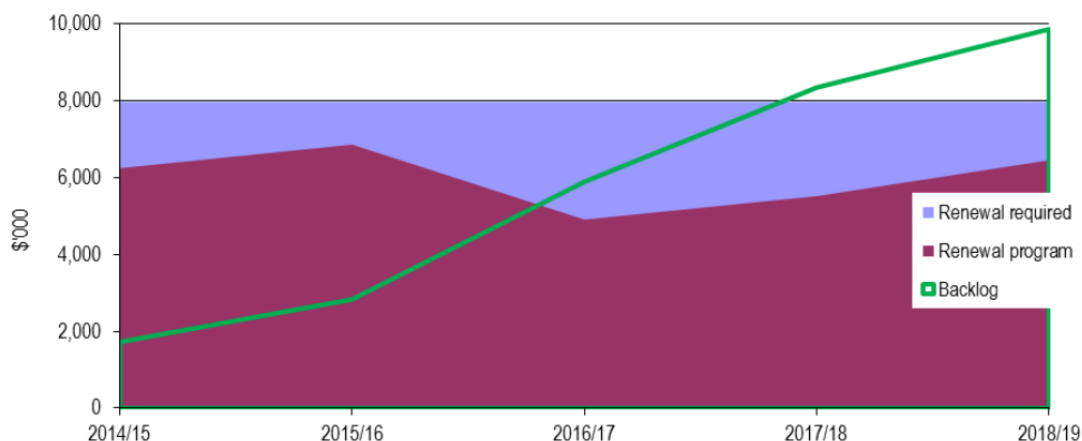
Rate increases of only 2.5% per annum would adversely impact on the above projections from 2016-17 onwards, by of the order of 0.4% compounding per annum.

It is noteworthy and probably revealing that Horsham gives little if any attention to its projected adjusted underlying result ratio in either its comprehensive 2015-16 budget document or in its application to ESC for a rate increase beyond the cap. Its budgeting strategy seems to be based primarily on generating additional revenue to increase spending on asset renewal.

If Horsham has prepared a long-term (10-year) financial plan Deloitte Access Economics is not aware of its existence and has not sighted information that would suggest the council has considered alternative expenditure and revenue raising strategies. For example, it is noted that in its 2015-16 budget and strategic resource plan to 2018-19, the council has flagged an intention to outlay over \$18 million (assumed to be in nominal values) on new assets and asset upgrades during the 3-year period from 2016-17 to 2018-19. These outlays will add to long-run operating costs (for example by increasing annual depreciation expenses). Presumably the council believes that such outlays are of higher priority than spending more on asset renewal.

Horsham highlighted in its 2015-16 budget that it expected its so called 'renewal backlog' would continue to increase over the period because it was unable to spend on asset renewal at the required level. The following graph was provided as part of their rate cap variation application.

Figure 1.1: Renewal program and accumulative renewal backlog



Source: Horsham Rate Cap Variation Application Version 6 (Final), page 20, 2016

Deloitte Access Economics has reservations regarding the consistency and objectivity with which councils determine asset renewal backlogs. A backlog is a function of amongst other things preferred service level decisions and revenue raising and use of debt strategies. Many (but not all) councils that claim to have significant asset renewal backlogs could have previously addressed these needs by spending less on other services, or raising more revenue and if warranted raising borrowings. The fact that they have not done so often means that they preferred this outcome to the alternatives.

In its 2015-16 budget and strategic resource plan to 2018-19, Horsham reported actual and forecast asset renewal outlays as a percentage of annual depreciation as shown below.

Table 1.2: Asset renewal

	2014-15	2015-16	2016-17	2017-18	2018-19
Asset renewal (as % of annual depreciation)	102%	102%	70%	79%	100%

Updated information is not available for this indicator based on the Council’s current preferred future rate increases or under a cap of 2.5% pa. In any event Deloitte Access Economics notes that it should not be assumed that asset renewal expenditure of the order of about 100% of the level of annual depreciation is necessarily desirable in any period (or even over the medium term). Asset renewal needs can be lumpy between periods and service level wishes can change over time.

Horsham has more than adequate current and projected ongoing liquidity and modest levels of debt. It has capacity to raise more debt in future if needed to accommodate large one-off (for example capital works) expenditure requirements providing it implements and maintains financial strategies that generate a satisfactory ongoing adjusted underlying operating result.

1.4 Concluding remarks

In the absence of clearer and more comprehensive information it is difficult to be confident regarding the merits of Horsham's rate capping application. The requested increase is modest and the council is projecting a small adjusted underlying deficit over the next few years and believes it has significant asset renewal needs that it would like to better address. These factors tend to support the application.

On the other hand it is not clear that the council has weighed up all the options regarding the best range and level of services that it can afford over the medium to longer-term and what this would mean for long-run rating levels. If it wishes to proceed with current expenditure plans over the next few years it is likely that it will require further rate increases beyond the rate cap in future.

There would be no material negative implications for the council from rate revenue being constrained to the cap in 2016-17. Regardless of the decision regarding the application for an increase beyond the cap for 2016/17 it would be wise for the council to undertake further work on developing an appropriate long-run financial and service level strategy before considering submitting an application for a rating increase for years beyond 2016-17.

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.

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