Deloitte Access Economics

Assistance with review of 2016-17 rate cap variation applications

Moorabool Shire Council

Essential Services Commission

Deloitte.

Contents

1 Moorabool Shire Council 1
1.1 Project background 1
1.2 Overview 1
1.3 Assessment of financial performance, position and outlook 2
1.4 Concluding remarks 3
Limitation of our work 5

1 Moorabool Shire Council

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 Moorabool 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.

1.2 Overview

Moorabool is a semi-rural municipality located between Melbourne and Ballarat. It currently has a population of 31,000 and is expecting ongoing population growth over the next 25 years of about 2.25% per annum. It has applied for a rate increase of 1.0% above the 2.5% rate cap and flagged that it is likely to apply for further increases in future. It estimates that the above the cap rate increase would generate additional revenue of about $260,000 in 2016-17.

Moorabool's submission demonstrated that it has a good understanding of strategic financial planning in a local government context. It is mindful of the need to operate in a financially sustainable manner and has modelled various financial options and considered their implications.

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

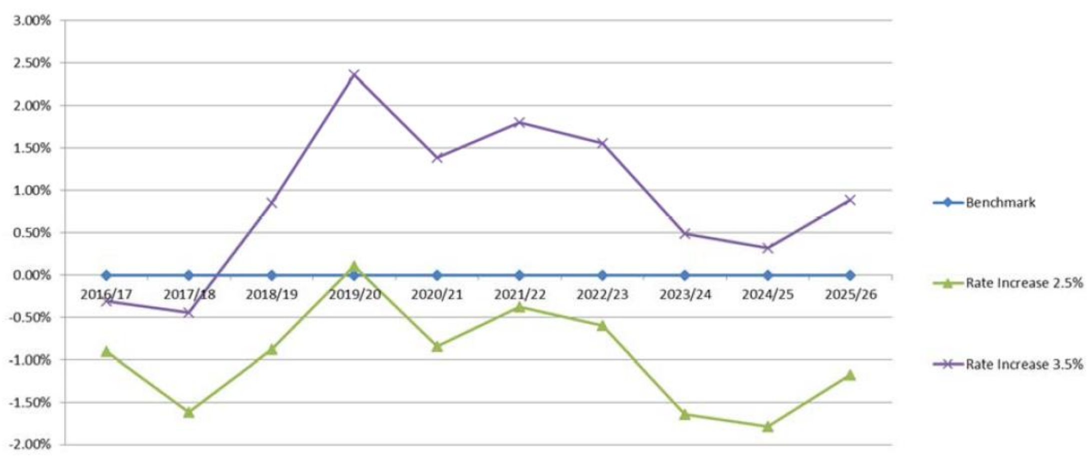
It states that it is seeking the additional increase this year (and at this stage is likely to seek similar increases in the following three years) in order to improve its underlying adjusted operating result, progressively and more quickly meet perceived asset renewal needs and help finance capital expenditure associated with upgrading and new assets. If its application is unsuccessful it has indicated that it will curtail its outlays on new assets and the upgrading of existing assets.

1.3 Assessment of financial performance, position and outlook

Moorabool budgeted for approximately $51 million in income in 2015-16, including $10 million in capital related grants and contributions. Budgeted rates and charges were $29 million.

Moorabool's budgeted expenses for 2015-16 are $44 million. It effectively budgeted for a small adjusted underlying operating deficit. It is projecting an ongoing small adjusted underlying operating deficit in future without an increase in rates as is shown in the figure below. The figure below also shows that this would become a small adjusted underlying operating surplus in future based on its assumptions, including its preferred rate increase strategy (1.0% above the assumed cap each year over the next 4 years).

Figure 1.1: Moorabool Shire SFP – projected underlying result

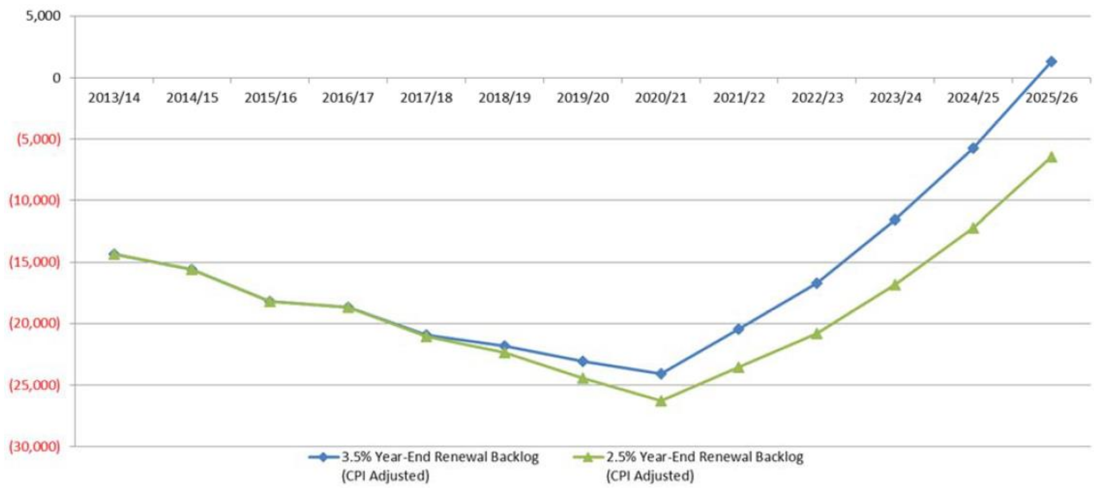


Source: Moorabool Rate Cap Variation Application – Criteria Response, page 5, 2016

Deloitte Access Economics supports Moorabool's strategy of giving priority to achieving a small positive ongoing operating result.

Moorabool notes that it has a significant asset renewal backlog that it is focussed on addressing. It has undertaken modelling that shows that it could satisfactorily deal with this perceived need over a shorter time period if it increased rates by 1% pa above the cap (assumed 2.5% pa) over the next 4 years. This is shown in the graph below.

Figure 1.2: Projected year-end renewal backlog



Source: Moorabool Rate Cap Variation Application – Criteria Response, page 9, 2016

Deloitte Access Economics has some 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 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 need be raising borrowings. The fact that they have not done so often means that they preferred this outcome to the alternatives. We accept though that Moorabool may have good grounds for desiring to spend more on asset renewal in future.

Deloitte Access Economics also has reservations regarding the meaningfulness of comparing asset renewal outlays with annual depreciation (the renewal gap ratio). In our view 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. Nevertheless it is worth noting that over the next 10 years Moorabool is projecting an average renewal gap ratio of 0.86 (spending on renewal at 86% of the level of annual depreciation) if average rate revenue per property rises at 2.5% per annum. If rates were increased by a further 1% per annum in the next 4 years it has calculated that the average renewal gap ratio would increase to 0.9.

Moorabool 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

Moorabool's projected ongoing adjusted underlying deficit tends to support its application for a modest increase in rates in 2016-17 above the cap. It appears committed to operating in a financially sustainable manner and has also made savings through service level reviews and efficiency gains to so assist.

The council could manage in 2016-17 without the sought after rate increase. However, its financial projections suggest it would in future need to make further savings if it did not receive the increase above the cap this year and possibly similar further increases over the next (or later) years. Any decision regarding future possible rate increases beyond 2016-17 are not a factor for consideration at this time. Should a further application be lodged in future it will need to take account of updated financial projections and other relevant information.

A key future consideration for Moorabool will be the careful financial management of the impact of growth. Growth could assist or hinder its future financial sustainability. If it plans well and is careful regarding the timing and extent of outlays on new assets and services then growth should assist the council in meeting its financial and service level objectives and help reduce the need for rate increases over the longer term.

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.

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