Deloitte Access Economics

Assistance with review of 2016-17 rate cap variation applications

City of Wyndham

Essential Services Commission

May 2016

Deloitte.

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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 Wyndham 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

Wyndham City is a large interface council on the south-western fringe of Melbourne. It serves a resident population of 201,000. This is expected to increase to 384,000 by 2036 with estimated growth over this period averaging over 3% per annum. Wyndham has applied for a rate increase of 2.0% above the 2.5% rate cap and this would generate additional revenue of about $3.0 million in 2016-17.

Wyndham has prepared estimates of required infrastructure and other asset outlays that will be required to satisfy preferred service levels associated with current and future growth. It is very conscious of the impact of accommodating these outlays and is

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

disappointed that recent decisions by the Victorian government will reduce funding contributions to it from developers.

The council has been increasing rates at about 5.5% per annum in recent years in order to help accommodate capital expenditure associated with growth and previously had planned to continue to increase rates annually in future at about this rate. It considers that it has no capacity to increase borrowings above levels already planned. Consequently it argues that it will need to delay or reduce future planned capital expenditure if rate income in future is lower.

It proposes to reduce capital expenditure by $3 million in 2016/17 if its application for an additional rate increase of 2.0% is unsuccessful. (Note it also proposes to generate slightly more revenue from sources other than rates and realise minor operating savings in order to make up the net cashflow shortfall compared with the previously proposed 5.5% rate increase.)

1.3 Assessment of financial performance, position and outlook

Wyndham budgeted for $360 million of income in 2015-16, including $76 million in capital related grants and contributions. Budgeted rates and charges were $162 million. Its budgeted expenses were $272 million. It effectively budgeted for a small adjusted underlying operating surplus result of $12 million.

Wyndham's 2015-16 budget and strategic resource plan included its projected underlying operating result ratio for 2015-16 and the following 3 years. That information is shown below and is based on an assumed rate increase of 5.5% per annum. Also shown in the table below is the updated adjusted underlying result that Wydham is now forecasting based on a 2.5% per annum rate cap and the impact of the sought after increase in 2016-17.

Table 1.1: Adjusted underlying result ratio

	2014-15	2015-16	2016-17	2017-18	2018-19
2015-16 budget	4%	4%	6%	8%	10%
Update based on 2.5% p.a. rate cap	-4%	2%	4%	5%	5%
Update based on 4.5% in 2016-17 & then 2.5% p.a.	-4%	2%	5%	6%	6%

Wyndham is forecasting a satisfactory ongoing adjusted underlying operating result over the planning period in its long-term (10-year) financial plan. Generally, councils in such circumstances should be able to maintain service levels on an ongoing basis. Hence, the only key issue then becomes whether there are future peaks in expenditure (particularly for example capital related) which would be difficult to accommodate. Wyndham claims that there are and that it needs additional revenue in order to finance such outlays.

It is highly likely that Wyndham will experience very significant population growth over the next 20 years. This growth will bring additional capital expenditure demands but it will also bring additional secure ongoing revenue. Wyndham claims a significant ‘funding gap’ (which appears to be the difference between outlay costs council would incur in providing preferred asset levels associated with growth and the monies received from developers to fund this work) of $337 million. It is not clear from the financial projections that Wyndham has provided as to what extent additional net revenues associated with growth could help offset this ‘funding gap’.

In any event providing that the council carefully plans and bases infrastructure provision and service levels on affordable long-run costs then there is no reason why it could not borrow at significant levels in order to help accommodate capital expenditure needs in excess of those that can be financed through operating net cashflow.

Wyndham highlights that it already is projecting to have debt of about $100 million by the end of the current 4-year planning period and that such a level would be high relative to other councils and commonly accepted targets for local governments in Victoria.

In Deloitte Access Economics’ view, given its operating environment and circumstances, Wyndham could borrow much more if required. For example borrowing another $100 million might add around $5 million per annum to long-run operating costs in additional financing charges. Under such a scenario Wyndham would still be likely to be generating adjusted underlying operating surpluses. Total financing charges would still represent less than 4% of total operating costs in these circumstances which would be modest for a council with secure and high long-run growth.

Wyndham may be concerned that additional loan repayments associated with substantial additional borrowings would put a strain on future net cashflow. Victorian councils typically borrow with loan periods of relatively short duration and with terms that require regular and relatively high annual (or more frequent) repayments. Councils with high debt needs and good long-term growth prospects may be better off varying borrowing arrangements, including repaying or even rolling over loans over longer timeframes.

The council could also reduce interest costs and interest rate risk exposure through improved treasury management practices. For example it currently holds monies in order to ‘cash back’ provisions for major liabilities (such as the future landfill closure). It claims that this ensures that these obligations are not borne by future ratepayers. However, holding monies in this way does not achieve the intended outcome. Ensuring that service levels and revenue raising are both set at levels that generate revenue that offsets the cost of operations is what is required to ensure that current obligations are not borne by future ratepayers. If future affordable outlays are greater than income inflows in any period, Wyndham would be better off to run-down cash holdings surplus to requirements in order to delay and reduce otherwise necessary borrowing costs.

Wyndham highlights that it has significant asset renewal needs as well as demand for high levels of new asset outlays but does not provide details in its submission. It has included projections for asset renewal outlays over the next 4 years as a percentage of the corresponding year's depreciation forecast (the asset renewal ratio) in its 2015-16 budget and strategic resource plan. That information is shown in the table below. The table also highlights the projected asset renewal ratio that Wydham is now forecasting based on a 2.5% per annum rate cap and the impact of the sought after increase in 2016-17.

Table 1.2: Asset renewal ratio

	2014-15	2015-16	2016-17	2017-18	2018-19
2015-16 budget	90%	22%	30%	36%	29%
Update based on 2.5% pa rate cap	83%	24%	29%	32%	30%
Update based on 4.5% in 2016-17 & then 2.5% pa	-4%	2%	30%	32%	30%

Deloitte Access Economics has some reservations regarding the consistency and objectivity with which councils determine asset renewal needs and 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.

Furthermore, in Deloitte Access Economics' 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. For example, growth councils with a high percentage of relatively new assets are typically likely to need to spend relatively little on asset renewal relative to depreciation on average over the short to medium term.

Relative to its circumstances and the nature of its operating environment, Deloitte Access Economics believes that Wyndham has more than adequate current and projected ongoing liquidity. Its 2015-16 budget and strategic resourcing plan identified that it planned to outlay more than $100 million per annum on average (assumed to be nominal values) over the following 4-year period on capital works. It planned to borrow $55 million during this period but cash on hand was expected to grow from $115 million to $147 million. Even under the rate cap scenario and with outlays unchanged it would still have more cash on hand at the end of the 4-year period than at the beginning.

1.4 Concluding remarks

Wyndham is a large council that's population is expected to grow very significantly over the next 20 years. It appears currently to be operating on a financially sustainable basis. Growth will bring financial challenges and in particular demands for additional expenditure.

Wyndham needs good strategic financial planning with decisions regarding the magnitude and timing of proposed capital expenditure and services based primarily on long-term affordability more so than short-run cashflow implications. It also needs a more flexible approach to net debt holdings and net debt management that is nevertheless responsible relative to its circumstances. On the available evidence there is no reason to think that an increase in rate revenue beyond the cap will be required in the near future.

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

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